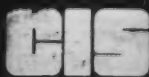


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# THE DEPARTMENT OF THE TREASURY'S REPORT ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICY

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## HEARING

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL FINANCE  
AND MONETARY POLICY

OF THE

COMMITTEE ON  
BANKING, HOUSING, AND URBAN AFFAIRS  
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

TO

EXPLORE THE ADMINISTRATION'S VIEW OF THE CONSEQUENCES OF  
THE CONTINUED DECLINE IN THE YEN FOR WORLD ECONOMIC STA-  
BILITY AND THE BALANCE OF TRADE AND THE APPROPRIATE RE-  
SPONSE BY THE G-7 COUNTRIES AND TO TOUCH UPON THE CONSE-  
QUENCES THAT THE MONETARY UNION OF GERMANY MIGHT HAVE  
FOR THE ECONOMIC COORDINATION PROCESS

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APRIL 19, 1990

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Printed for the use of the Committee on Banking, Housing, and Urban Affairs



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# THE DEPARTMENT OF THE TREASURY'S REPORT ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICY

THURSDAY, APRIL 19, 1990

U.S. SENATE, COMMITTEE ON BANKING, HOUSING, AND  
URBAN AFFAIRS, SUBCOMMITTEE ON INTERNATIONAL FI-  
NANCE AND MONETARY POLICY,

*Washington, DC.*

The subcommittee met at 10:10 a.m., in room SD-538 of the Dirksen Senate Office Building, Senator Paul Sarbanes (chairman of the subcommittee on International Finance and Monetary Policy) presiding.

Present: Senators Sarbanes, Shelby, Heinz, and Dixon.

## OPENING STATEMENT OF SENATOR SARBANES

Senator SARBANES. The subcommittee will come to order. Today, the Subcommittee on International Finance and Monetary Policy holds one in a series of regular hearings to review the Treasury's update of its report on International, Economic and Exchange Rate Policy.

Less than 2 weeks ago, the group of seven industrial countries held a special meeting in Paris at the suggestion of Treasury Secretary Brady to strengthen international economic coordination during a period of extraordinary changes in the world economy.

When the special meeting was announced in early March, an important issue prompting the meeting was the prospect of monetary union of West Germany and East Germany, and the possibility of a one for one exchange of East German marks for Western German marks, that raised some question about possible inflationary pressures in West Germany and an accompanying rise in interest rates, and the possible adverse impact on the world economy.

While this remained an issue of concern at the April 7 meeting of the major industrial countries, the decline in the value of the yen over the last year apparently became the focus of much of the discussion.

Over the last 16 months, the dollar has declined 30 percent against the yen, 10 percent since the beginning of this year alone. Over time, a continued decline in the yen and appreciation in the dollar could have significant consequences for the U.S. balance of trade with Japan, which already presents a difficult problem.

The communique issued by the G-7 countries after the meeting stated that the yen's decline had, quote, "undesirable consequences," for world economic adjustments. And that the group of

seven had agreed to keep financial market developments, especially the yen's decline, under review.

The countries reaffirmed their commitment to economic policy coordination, including cooperation and exchange markets, but did not respond to suggestions for coordinated interest rate actions to support the weak Japanese currency.

This morning, the subcommittee will explore the administration's view of the consequences of the continued decline in the yen for world economic stability and the balance of trade and the appropriate response by the G-7 countries.

The subcommittee also will touch upon the consequences that the monetary union of Germany might have for the economic coordination process, as well as the outlook for the upcoming, regularly-scheduled meeting of the G-7 in Washington on May 7.

In addition, the subcommittee will review the Treasury's latest assessment of the practice of currency manipulation by other countries in order to gain a competitive trade advantage in the United States.

We are very pleased to have with us this morning, the Under-Secretary of the Treasury for International Affairs, to review the Treasury report on International Economic Policy and Exchange Rates.

Mr. Secretary, before I turn to you, I'll turn to my colleague, Senator Shelby, for an opening statement he may have.

Senator SHELBY. Mr. Chairman, I just want to mention Mr. Mulford. He's no stranger to this committee. He's here about every other week.

I look forward to your testimony.

Senator SARBANES. Your full statement will be included in the record.

Secretary Mulford, we are prepared to hear from you.

If you would desist for just a moment, we've been joined by Senator Heinz, whose had not only a long-standing interest in this issue, but has crafted and shaped important legislation with respect to it.

We'd be happy to hear from Senator Heinz.

Senator HEINZ. Mr. Chairman, I don't want to interrupt David Mulford. I would ask unanimous consent that my statement be placed in the record as if given in full. And I would ask you please to proceed.

Welcome. I'd like to welcome Mr. Mulford back to the committee. He has to spend as much time here as he does at his desk.

Thank you, Mr. Chairman.

#### STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, I would like to join you in welcoming Under Secretary Mulford to the committee today to continue the dialogue on international economic policy that the committee mandated in the 1988 trade bill. The report gives little guidance on where the policy process should go from here, but it does include one bit of good news regarding South Korea. Treasury has now concluded that Korea, like Taiwan last year, has introduced sufficient market-based reforms that neither country should any longer be classified as manipulating their currency. The Korean economic situation is sufficiently murky that I am not sure I share Treasury's confidence, but any shift in policy is welcome and we will watch the situation closely.

The report, while supportive of the G-7 governments' policy coordination process, seems to indicate less hope for its future. There is little indication that governments

see much scope for altering domestic policies to better coordinate them with the rest of the G-7. The United States is pursuing a fiscal policy of slow budget deficit reduction and tight monetary policy to control inflation. While these policies are producing continuing slow growth, our large trade deficits and a dollar rising in value against the yen offer poor prospects for U.S. external adjustment.

Japan is under pressure to increase interest rates to support the yen and restrain inflation but unable to act for fear of a dive by the nervous Japanese stock market. The G-7 has taken no action in response to Japan's difficulties. Germany is pledged to monetary and political union with the East, at a potentially inflationary 1:1 conversion rate, that will define its policy for years to come.

With the major players locked into a set of inward looking policies and with little room for maneuver, it is far from clear whether there is room for meaningful policy coordination. I look forward to Dr. Mulford's views on whether there is hope for the process and where we go from here.

Senator SARBANES. Hopefully to good advantage, the full statement will be included in the record.

Secretary Mulford.

**STATEMENT OF DAVID MULFORD, UNDER SECRETARY FOR INTERNATIONAL AFFAIRS, DEPARTMENT OF THE TREASURY, WASHINGTON, DC**

Secretary MULFORD. Thank you, Mr. Chairman and members of the committee. It's a great pleasure to be here today to discuss the Treasury's report on International Economic and Exchange Rate Policies. This report and the consultations with Congress on U.S. International Economic Policy have proven to be highly effective in broadening understanding of the world economy and in advancing U.S. international economic objectives.

I would like to examine two aspects of U.S. international economic policy.

First, the economic policy coordination process and, second, developments in Korea and Taiwan.

The economic policy coordination process has contributed importantly to the strength and performance of the world economy over the past years. This process has helped policy makers put in place consistent and compatible policies necessary for sustained global growth, low inflation and reduced external imbalances.

The G-7's record of success in this regard is quite impressive. The economic expansion is now being sustained into its eighth consecutive year. Inflation has been substantially reduced from the high levels of the late 1970's and early 1980's. World trade growth has been robust facilitating external adjustment.

Also, the major countries have put in place policies to rein in public spending, reform tax regimes, liberalize financial markets and reduce excessive red tape and Government regulation in general.

1989 represented another solid year of performance for the G-7 economies' growth; after recording an extremely vibrant increase of 4.4 percent in 1988, their combined growth rate eased to a still healthy and strong 3.4 percent in 1989.

Though consumer price inflation rose approximately 1 percentage point in 1989 to an average rate of about 4.5 percent, much of this increase took place in the first half of the year and was associated in part with special one-time factors.

Recent data indicate that inflation pressures persist for the G-7 countries as a group, although for some countries, the recent in-

crease in large measure reflects temporary commodity price developments, more than underlying problems.

We continue to expect that important factors, such as moderating demand growth and the unwinding of some of the negative influences that adversely affected the January and February price indices, such as oil and food, will dampen price pressures this year.

As these influences move through the markets into consumer prices, the core rate of inflation is expected to return to previous levels. Nevertheless, it is clear that continued vigilance will be required.

External imbalances again declined substantially in the United States and Japan in 1989. In the United States, the current account deficit fell by a further \$21 billion to \$106 billion, the lowest deficit since 1984, and substantially down from the \$144 billion deficit in 1987.

Japan's current account surplus declined from roughly \$80 billion in 1988 to \$57 billion in 1989. The combined surplus of the EC countries was reduced from a peak in 1986 of \$51 billion to a level in 1989 of only \$2 billion.

And if you combine the newly-industrialized economies which had a figure of \$30 billion surplus in 1987, that has been reduced to a surplus of \$23 billion in 1989, the prospects for G-7 performance in 1990 remain quite favorable. Overall growth prospects remain good. With growth in the major countries projected to ease only slightly from the rate recorded in 1989, world trade should continue expanding solidly.

Despite these achievements, I do not wish to seem complacent. Challenges lie before us in the period ahead. External imbalances remain large and the adjustment process slowed over the course of 1989. In Europe, significant external imbalances have emerged with Germany registering a massive current account surplus of \$53 billion in 1989 or 4.4 percent of its GNP, the largest such ratio within the G-7 group.

Current account trends are difficult to project with certainty, but it would appear that any further improvement in the U.S. current account's position in 1990 will, at best, be very modest and the possibility of a deterioration in the current account cannot be excluded.

Also over the past 6 months, significant changes in the world economy have taken place. These include the changes in Eastern Europe, political and economic life, and developments in global financial markets, particularly in Japan.

The G-7 finance ministers and central bank governors met against this background in Paris on April 7th. They reaffirmed their commitment to economic policy coordination as the best means of addressing these developments.

In this context, the Ministers and Governors noted the shared responsibility of surplus and deficit nations in promoting sustained growth, reduced external imbalances and greater stability of exchange rates.

The United States is doing its part. We have achieved significant progress in reducing the U.S. budget deficit. From a peak of 6.3 percent of GNP in fiscal year 1983, the Federal budget deficit was

reduced to 2.9 percent in FY 1989 and is projected to decline further, to 2.3 percent in FY 1990.

Combining Federal, State and local governments, our deficit in fiscal year 1990 is projected to be around 1-1.5 percent of GNP. Personal saving in the United States is returning toward the historic average level and the administration has made a number of proposals to improve the national savings rate. The most important step in this process is to continue to reduce the budget deficit.

Developments in Eastern Europe and efforts to achieve market-oriented economies in this region are among the most profound and welcome events in decades.

Also, the prospective reunification of the Germany economies should contribute to improved global growth and to a reduction of external imbalances.

This will be a most welcome development, particularly in light of Germany's massive surpluses. The Japanese yen has depreciated sharply in recent months against the world's major currencies. This is an important matter of concern and one that may have undesirable consequences for the global adjustment process.

The weakness of the yen and Japanese financial market developments more broadly must be viewed in the context of the sharp appreciation of Japanese asset values over the past several years.

These financial market developments may have been further accentuated by the lack of a deep and liquid money market for yen-denominated instruments.

We will continue to address these issues in our yen/dollar talks, which take place again in late May.

On balance, the underlying fundamentals of the Japanese economy remain sound. Nonetheless, the depreciation of the yen, together with Japan's relatively closed markets, is not a sustainable situation over time. Their continuation would pose important risks for the world economy.

We will be keeping these developments under close review and we will continue to cooperate with other G-7 countries on exchange markets.

We have achieved a progress in our bilateral negotiations and discussions with Korea and Taiwan. Both Korea and Taiwan have instituted more market-based systems for determining the exchange rate. Korea's external surplus has sharply declined, and Taiwan's gives us evidence of moving in the right direction.

We still have concerns, however, which I will discuss in the remainder of my testimony. Since the October 1988 report, the New Taiwan dollar has strengthened by 10 percent against the U.S. dollar, more than that of any other major trading partner. Between May of 1989 and early March of this year, the exchange rate fluctuated narrowly against the U.S. dollar. Subsequently, it depreciated by 1 percent before strengthening slightly. The depreciation was the result of short-term speculation and capital outflow in response to political uncertainties. The Central Bank resisted the depreciation recognizing that it did not reflect Taiwan's strong economic fundamentals and would fuel inflation.

In absolute terms, Taiwan's global current account surplus rose by 9.5 percent last year to \$11.2 billion. The U.S. trade deficit with Taiwan also increased by 3 percent in 1989 to \$13 billion. If, howev-

er, one-time extraordinary purchases of gold from the United States by Taiwan's Central Bank in 1988 are excluded, the Taiwanese current account surplus and the U.S. bilateral trade imbalance with Taiwan fell by 15 percent, and 14 percent respectively last year.

Since the October 1989 report, Taiwan has taken further steps to liberalize its new exchange rate system, although remaining capital and foreign exchange restrictions continue to limit supply and demand in the exchange market.

In light of these developments, we remain of the view that there are no clear indications that Taiwan is, quote/unquote, "manipulating the exchange rate for competitive advantage."

Taiwan's large external surpluses, however, remain unsustainably high. The Taiwanese authorities need to recognize the need for the further reduction of the surpluses and the continued importance of the exchange rate, and of the liberalization of remaining capital and exchange controls in advancing this adjustment process.

We will continue to monitor the situation closely. Since the release of the October 1988 report, the Korean won has appreciated by only ½- of 1 percent in nominal terms against the U.S. dollar from the won's strongest point against the dollar shortly following the April 1989 report.

Since the October report, however, the won has appreciated 25 percent against the yen, including 13 percent since April of 1989. Thus, on a trade-weighted basis, the won has appreciated an estimated 7 percent since the October 1988 report.

Korea has made considerable progress last year in reducing its external surpluses. The current account surplus fell 64 percent to \$5.1 billion compared to the same period last year. This is equal to 2.5 percent of GNP following an 8.4 percent ratio in 1988.

Also, our bilateral trade deficit with Korea declined by 30 percent to \$6.3 billion. On a quarterly basis, our bilateral trade deficit with Korea has shown no significant growth since the beginning of 1988.

These declines continued in January-February of this year, and the prospects are for somewhat lower imbalances this year than last.

These welcome declines reflect a number of factors. The won's past currency appreciation, both against the dollar and the non-dollar currencies, is a principal cause. Large wage increases in 1988 and 1989 exceeding productivity gains are another important factor contributing both to higher export prices and to higher import demand.

Korea's ongoing trade liberalization program also facilitated import growth. Severe labor/management disputes also played an important role in restraining Korea's export growth last year. Korea's introduction of a new market average rate system of exchange rate determination in March of this year is an important development.

This system's success, however, will depend on how it is implemented. The liberalization of pervasive foreign exchange and capital controls is especially necessary to allow market forces to play a greater role.

Also of significance, the Treasury and Korea's Ministry of Finance initiated financial policy talks in late February. We hope to make progress in these talks on problems facing U.S. banks and securities firms in getting access to the Korean market.

The initial round of these talks produced some indications of flexibility in some areas, but follow-up actions have yet to be taken and much more remains to be done in subsequent meetings.

Since introduction of the new exchange rate system, there is a lack of evidence of continued direct Government manipulation of the exchange rate within the meaning of the legislation, particularly in view of the developments in the Korean external accounts.

We, nonetheless, remain concerned about the won's nominal depreciation against the dollar. The recent policy measures which aim to increase exports add to our concerns as they could delay the adjustment process.

We will, therefore, continue to monitor Korea's trade and exchange rates developments carefully and press for further liberalization of the financial capital and exchange markets in the financial policy talks.

That concludes my remarks, Mr. Chairman.

Thank you very much.

[The complete prepared statement of David C. Mulford follows:]

STATEMENT OF THE HONORABLE  
DAVID C. MULFORD  
UNDER SECRETARY OF THE TREASURY  
FOR INTERNATIONAL AFFAIRS  
BEFORE THE  
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS  
SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY  
UNITED STATES SENATE  
APRIL 19, 1990

Mr. Chairman and members of the Committee:

It is a great pleasure to be here today to discuss with you the Department of the Treasury's report on international economic and exchange rate policy. This report and the consultations with Congress on U.S. international economic policy have proven to be highly effective in broadening understanding of the world economy and in advancing U.S. international economic objectives.

I would like to examine two aspects of U.S. international economic policy. First, the economic policy coordination process and our efforts to promote a strong and smoothly functioning world economy. Second, developments in Korea and Taiwan, two economies with an important role to play in the international adjustment process, in view of their sizable external surpluses and growing responsibilities in the world economy.

Economic Policy Coordination

The economic policy coordination process has contributed importantly to the strengthened performance of the world economy over the past years. This process has helped policymakers to better understand the international ramifications of their domestic policies. It has also helped them to put in place the consistent and compatible policies necessary for sustained global growth, low inflation, and reduced external imbalances.

The G-7's record of success in this regard is quite impressive. The economic expansion is now being sustained into its eighth consecutive year. Inflation has been substantially reduced from the high levels of the late seventies and early eighties. World trade growth has been robust, facilitating external adjustment. Also, I would note Mr. Chairman -- and this is a point which often does not receive adequate attention -- that the major countries have put in place policies to rein in public spending, reform tax regimes, liberalize financial markets, and reduce excessive red-tape and government regulation in general.

1989 represented another solid year of performance for the G-7 economies. Growth, after recording an extremely vibrant increase of 4.4 percent in 1988, eased to a still healthy and strong 3.4 percent in 1989. Though consumer price inflation rose approximately 1 percentage point in 1989, to an average rate of about 4-1/2 percent, much of this increase took place in the first half of the year and was associated in part with special one-time factors.

Recent data indicate that inflation pressures persist for the G-7 countries as a group, although for some countries the recent increases in large measure reflect temporary commodity price developments more than underlying problems. We continue to expect that important factors -- such as moderating demand growth and the unwinding of some of the negative influences that adversely affected the January and February price indices (oil and food) -- will dampen price pressures this year. As these influences move through the markets into consumer prices, the core rate of inflation is expected to return to previous levels. Nevertheless, it is clear that continued vigilance will be required.

External imbalances again declined substantially in the United States and Japan in 1989. In the United States, the current account deficit fell by a further \$21 billion to \$106 billion, the lowest deficit since 1984, and substantially down from the \$144 billion deficit in 1987. Japan's current account surplus declined from roughly \$80 billion in 1988 to \$57 billion in 1989 and the overall surplus of the European Community has been reduced to nearly zero.

Moreover, the prospects for G-7 performance in 1990 remain quite favorable. Overall growth prospects remain good, with growth in the major countries projected to ease only slightly from the rate recorded in 1989. World trade should continue expanding solidly.

Despite these achievements, I do not wish to seem complacent. Challenges lie before us in the period ahead.

External imbalances remain large and the adjustment process slowed over the course of 1989. In Europe, significant external imbalances have emerged, with Germany registering a massive current account surplus of \$53 billion in 1989, or 4.4 percent of GNP, the largest such ratio in the G-7. Current account trends are difficult to project with certainty, but it would appear that any further improvement in the U.S. current account position in 1990 will at best be very modest, and the possibility of a deterioration in the current account cannot be excluded.

Also, over the past six months, significant changes in the world economy have taken place. These include the changes in Eastern European political and economic life and developments in global financial markets, particularly in Japan. The G-7 Finance Ministers and Central Bank Governors met against this background in Paris on April 7. They reaffirmed their commitment to economic policy coordination as the best means of addressing these developments.

In this context, the Ministers and Governors noted the shared responsibility of surplus and deficit nations in promoting sustained growth, reduced external imbalances, and greater stability of exchange rates. The United States is doing its part. We have achieved significant progress in reducing the U.S. budget deficit. From a peak of 6.3 percent of GNP in FY 1983, the Federal budget deficit was reduced to 2.9 percent in FY 1989 and is projected to decline further to 2.3 percent in FY 1990. Combining Federal, state, and local governments, our deficit in FY 1990 is projected to be around 1 to 1-1/2 percent of GNP. Personal saving is returning to the historical average level in the United States and the Administration has made a number of proposals to improve the national saving rate. The most important step in this process is to continue to reduce the budget deficit.

Developments in Eastern Europe and efforts to achieve market-oriented economies in this region are among the most profound and welcome events in decades. Also, the prospective reunification of the German economies should contribute to improved global growth and to a reduction of external imbalances. This will be a most welcome development, particularly in light of Germany's massive surpluses.

The Japanese yen has depreciated sharply in recent months against the world's major currencies. This is an important matter of concern, and one that may have undesirable consequences for the global adjustment process. The weakness of the yen, and Japanese financial market developments more broadly, must be viewed in the context of the sharp appreciation in Japanese asset values over the past several years. These financial market developments may have been further accentuated by the lack of a deep and liquid money market for yen-denominated instruments. We will continue to address these issues in our yen/dollar talks which take place again in late May.

On balance, the underlying fundamentals of the Japanese economy remain sound. Nonetheless, the depreciation of the yen and Japan's relatively closed markets are not sustainable over time as their continuation would pose important risks for the world economy. We will be keeping these developments under close review and we will continue to cooperate with other G-7 countries on exchange markets.

#### Asian Newly Industrialized Countries

Other economies have an obligation to assume a greater responsibility for contributing to the reduction of the world's external imbalances and promoting a sound and growing world economy. In particular, the newly industrialized economies of Asia are playing an increasingly important role in the world economy. Some of these economies have sizable external surpluses.

The Omnibus Trade and Competitiveness Act of 1988 recognized that undervalued currencies can be unfairly exploited to build up sizable external surpluses. The Treasury Department concluded in its October 1988 report on International Economic and Exchange Rate Policy that Korea and Taiwan "manipulated" their exchange rates within the meaning of the legislation. Following this report, we initiated bilateral negotiations with Korea and Taiwan, aimed at assuring that their exchange rate and other policies contributed to the adjustment of global imbalances. In October 1989, we concluded that there were no clear indications at that time that Taiwan was "manipulating" its currency for competitive advantage within the meaning of the legislation, given the introduction of its new exchange rate system and certain other factors. Regarding Korea, however, the Treasury determined there were indications of continued manipulation.

We have achieved progress in our bilateral negotiations and discussions with Korea and Taiwan. Both Korea and Taiwan have instituted more market-based systems for determining the exchange rate. Korea's external surplus has sharply declined and Taiwan's gives evidence of moving in the right direction. We still have concerns, however, which I will discuss in the remainder of my testimony.

Since the October 1988 report, the New Taiwan dollar has strengthened by 10 percent against the U.S. dollar, more than that of any major trading partner. Between May 1989 and early March of this year, the exchange rate fluctuated narrowly against the U.S. dollar. Subsequently it depreciated by 1 percent, before strengthening slightly. The depreciation was the result of short-term speculation and capital outflow in response to political uncertainties. The Central Bank resisted the depreciation, recognizing that it did not reflect Taiwan's strong economic fundamentals and would fuel inflation.

In absolute terms, Taiwan's global current account surplus rose by 9.5 percent last year to \$11.2 billion. The U.S. trade deficit with Taiwan also increased by 3 percent in 1989 to \$13 billion. If, however, one-time extraordinary purchases of gold from the United States by Taiwan's Central Bank in 1988 are excluded, the Taiwanese current account surplus and the U.S. bilateral trade imbalance with Taiwan fell by 15 percent and 14 percent, respectively, last year.

Following our bilateral negotiations last year, Taiwan instituted a new and liberalized exchange rate system in April 1989. Most foreign exchange transactions under the system are now freely determined and the authorities' ability to manipulate the rate has been greatly reduced. Since the October 1989 report, Taiwan has taken further steps to liberalize the system, although remaining capital and foreign exchange restrictions continue to limit supply and demand in the exchange market.

In light of these developments, we remain of the view that there are no clear indications that Taiwan is "manipulating" the exchange rate for competitive advantage. Taiwan's large external surpluses, however, remain unsustainably high. The Taiwanese authorities need to recognize the need for the further reduction of the surpluses and the continued importance of the exchange rate and of the liberalization of remaining capital and exchange controls in advancing this adjustment process. We will continue to monitor the situation closely.

Since the release of the October 1988 report, the Korean won has appreciated by only 1/2 percent in nominal terms against the U.S. dollar. From the won's strongest point, shortly following the April 1989 report, it has depreciated by about 6 percent in nominal terms against the dollar. Since the October report, however, the won has appreciated 25 percent against the yen, including 13 percent since April 1989. Thus, on a trade-weighted basis, the won has appreciated an estimated 7 percent since the October 1988 report.

Following the introduction of a new exchange rate system on March 2, the won has depreciated by 1.8 percent against the dollar, but has appreciated over 3 percent against the yen. These developments largely reflect Korea's trade and current account deficits in the first two months of this year, and capital outflows prompted by the possible introduction of a "real name" financial system (which has now been indefinitely postponed).

Korea made considerable progress last year in reducing its external surpluses. The current account surplus fell 64 percent to \$5.1 billion compared to the same period last year. This is equal to 2.5 percent of GNP, following a 8.4 percent ratio in 1988. Also, our bilateral trade deficit with Korea declined by 30 percent to \$6.3 billion. On a quarterly basis, our bilateral trade deficit with Korea has shown no significant growth since the beginning of 1988. These declines continued in January-February of this year and the prospects are for somewhat lower imbalances this year than last.

These welcome declines reflect a number of factors. The won's past currency appreciation, both against the dollar and non-dollar currencies, is a principal cause. Large wage increases in 1988-89 exceeding productivity gains are another important factor, contributing both to higher export prices and to higher import demand. Korea's on-going trade liberalization program also facilitated import growth. Severe labor-management disputes also played an important role in restraining Korea's export growth last year.

Korea's introduction of a new "market average rate" system of exchange rate determination in March is an important development. Under this system, the won/dollar exchange rate at the beginning of each business day is set equal to the weighted average interbank rate on the previous day's transactions. This system's success, however, will depend on how it is implemented. The liberalization of pervasive foreign exchange and capital controls is especially necessary to allow market forces to play a greater role.

Also of significance, the Treasury and Korea's Ministry of Finance initiated Financial Policy Talks in late February. We hope to make progress in these talks on problems facing U.S. banks and securities firms in gaining access to the Korean market. The initial round of these talks produced some indications of flexibility in some areas, but follow-up actions have yet to be taken and much more remains to be done in subsequent meetings.

Since introduction of the new exchange rate system, there is a lack of evidence of continued direct government "manipulation" of the exchange rate, within the meaning of the legislation, particularly in view of the developments in the Korean external accounts. We nonetheless remain concerned about the won's nominal depreciation against the dollar. The recent policy measures which aim to increase exports add to our concerns as they could delay the adjustment process. We will, therefore, continue to monitor Korea's trade and exchange rate developments carefully and press for further liberalization of the financial, capital, and exchange markets in the Financial Policy Talks.

#### Conclusion

The United States is committed to cooperating with its major trading partners to promote the sound world economy and stable financial system on which all countries' prosperity rests. The success of this effort will also require that the Executive Branch and the Congress work closely to deal with difficult domestic issues. Our dialogue on the international aspects of U.S. economic and exchange rate policies is an important element in this effort.

Thank you, Mr. Chairman.

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DEPARTMENT OF THE TREASURY

Report to the Congress

on

International Economic and Exchange Rate Policy

April 1990

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PART I: INTRODUCTION

Section 3005 of the Omnibus Trade and Competitiveness Act of 1988 (Pub. L. 100-418) requires the Secretary of the Treasury to submit to the Committee on Banking, Housing and Urban Affairs of the Senate and the Committee on Banking, Finance and Urban Affairs of the House of Representatives an annual report each October 15 on international economic policy, including exchange rate policy. In addition, Section 3005 requires that the Secretary shall provide a written update of developments six months after the initial report. Annual reports, pursuant to Section 3005, have been submitted in October of 1988 and 1989. The first written update of developments was submitted in April 1989. This report represents the second written update of developments submitted to Congress.

Part II of this report reviews the economic situation in the industrial countries, including the U.S. economic and balance of payments situation. Part III analyzes the situation in the foreign exchange markets, including the dollar's movement in terms of the currencies of major U.S. trading partners and U.S. foreign exchange market intervention. Part IV reviews efforts by the major industrial countries to coordinate economic policies. Part V provides a status report on negotiations with Korea, which was considered in the October 1989 report to be "manipulating" its exchange rate, within the meaning of the legislation. It also reviews developments in Taiwan. The final part provides conclusions on the principal issues discussed in the report.

PART II: ECONOMIC SITUATION IN THE INDUSTRIAL  
COUNTRIES AND THE U.S. BALANCE OF PAYMENTS

o Overview

The economic expansion in the industrial countries continued through its seventh consecutive year in 1989, at an average rate that was, as expected, somewhat below the very strong pace of 1988. Aggregate real GNP growth is expected to ease a bit further this year, to a still satisfactory rate of about 3.0 percent, with a greater divergence in the performance of individual countries reflecting both policy measures and cyclical factors. Prospects for continued steady growth remain good.

Substantial progress was made last year in reducing the trade and current account imbalances of the United States and Japan. However, the external imbalances of other major countries, such as Germany and the United Kingdom, increased further in 1989, and the underlying pace of the overall adjustment process appears to have slowed in some important respects. Nevertheless, market opening measures in Eastern Europe and, particularly, the economic integration of West and East Germany, could provide substantial impetus to the external adjustment process over time, especially within Europe.

Consumer price inflation in the industrial countries rose by approximately one percentage point in 1989, to an average rate of about 4.5 percent. The increase, which was broadly consistent with expectations, in part reflected the influence of some special, transitory, factors during the first half of the year. Since then, however, price pressures have generally moderated or stabilized, and the average inflation rate is likely to slip back marginally to slightly below 4 percent in 1990. (See Table 1.)

o Economic Growth

Basic developments in real GNP and its components were remarkably uniform in the major industrial countries in 1989. Specifically, after GNP growth rates picked up strongly in 1988 (to what, for several countries, were decade highs), there was a broadly shared slowdown in 1989. Japanese growth dipped to 4.9 percent (still the strongest rate in the G-7), and U.S. growth to 3.0 percent; the largest declines were registered for the United Kingdom and Canada (to 2.3 and 2.9 percent, respectively); only in Germany was GNP growth stronger in 1989 than in 1988 (4.0 percent vs. 3.6 percent). Aggregate GNP growth for the G-7 countries was an estimated 3.4 percent last year, after 4.5 percent in 1988. Domestic demand followed a similar course, with G-7 growth easing from 4.7 percent in 1988 to 3.4 percent in 1989.

Two major factors accounted for the bulk of last year's domestic demand slowdown. First, while investment activity remained generally strong, there was a fairly widespread easing from the unexpectedly high growth rates in 1988. Contributing to the slowdown were a moderate scaling back of investment plans in the wake of the large increases in recent years, narrowed profit margins, and anticipation of a period of somewhat weaker demand growth ahead. Second, private consumption growth declined in each of the G-7 countries in 1989, pulling the aggregate growth rate from 3.7 percent in 1988 to about 3 percent; among the contributing factors were the limiting effects of selected tax and social payment increases and higher inflation on real disposable income gains, as well as, in some cases, higher household saving.

Aggregate macroeconomic developments in the United States and Japan continued to provide solid support for the current account adjustment process. In the United States, domestic demand grew more slowly than GNP for the third consecutive year, and improving net exports once again provided a significant growth impetus. The reverse was the case in Japan, where domestic demand growth again substantially exceeded GNP growth and net exports declined significantly. In Germany, however, domestic demand growth weakened appreciably (due in part to fiscal tightening), and lagged GNP growth by a considerable margin; rising net exports were thus an important source of overall growth. Macroeconomic developments in the United Kingdom (with a very large current account deficit) moved strongly in the direction of adjustment in 1989 as domestic demand growth cooled from its unsustainably high rate in 1988. Nevertheless, domestic demand growth in the United Kingdom (as well as in Canada) remained in excess of GNP growth.

Macroeconomic trends are expected to be broadly supportive of external adjustment within the G-7 again this year. As domestic demand growth eases further in the largest deficit countries (the United States, the United Kingdom and Canada), net exports should also improve. Although domestic demand growth in Japan is not likely to be as strong as in 1989, it should again exceed GNP growth, with net exports contracting further. Modest real external adjustment is likely in Germany as well this year, as a tax cut and economic integration with the German Democratic Republic boost domestic demand. Over the longer term, German economic and monetary union should have a positive and substantial effect in reducing Germany's external imbalances.

#### Trade and Current Account Developments

World trade in 1989 largely reflected the macroeconomic developments discussed above: trade volume growth was not quite as robust as in 1988 (at 9.1 percent, the best year of the decade), but nevertheless remained quite strong (about 7.5 percent). Thus, the relationship between trade and output growth continues to track well with historical experience (roughly a 2:1 ratio).

The external imbalances of the two largest economies, the United States and Japan, declined substantially in 1989. Latest available data indicate that the U.S. current account deficit fell about an additional \$21 billion in 1989, from \$126.5 billion to \$105.9 billion (2.0 percent of GNP); the trade deficit fell to \$113.2 billion (2.2 percent of GNP). Japan's current account surplus declined from \$79.6 billion in 1988 to \$57 billion in 1989 (2.0 percent of GNP), and its trade surplus from \$95 billion to \$77.1 billion (2.7 percent of GNP). The aggregate current account surplus of the European Community (EC) fell to nearly zero last year after having been as high as \$51 billion in 1986.

However, the overall external adjustment of the EC conceals some major imbalances that have developed among Community members. In particular, Germany's trade and current account surpluses continued to rise in 1989; at \$72 billion and \$53 billion, respectively, the German imbalances represent 6.5 and 4.4 percent of GNP, the largest such ratios in the G-7. The bulk of the increase in German surpluses has come in trade with other EC member countries, with which Germany's surplus has more than tripled since 1985. However, the impact of the growing German surpluses on the overall external position of the EC has been essentially offset by rising deficits in other member countries, especially the United Kingdom and Spain. The trade and current account deficits of the United Kingdom increased somewhat further in 1989, to \$37 billion (4.5 percent of GNP) and \$33 billion (4 percent of GNP), respectively.

These external account trends in 1989 partly reflect developments in the relative growth rates of exports and imports in individual countries. In the United States, real exports of goods and services (measured on the national accounts basis) increased nearly 11 percent (the third consecutive year of double digit growth) while import growth was 6.4 percent. Import growth of 21 percent in Japan again exceeded export growth (about 15 percent), though the latter strengthened substantially last year. In Germany, however, export growth accelerated to just over 10 percent, exceeding import growth of about 7 percent; and while import growth in the United Kingdom slowed and export growth strengthened, the former still exceeded the latter by about 7 percent to 4 percent.

Thus, underlying trade flows present a mixed picture of adjustment. U.S. trends continue to favor adjustment, though the pace of export growth has cooled; in Japan, import growth remains strong, but export growth has revived considerably; export growth revived strongly as well in Germany, but imports picked up only marginally.

Against the background of these underlying trends, and in light of the macroeconomic projections reviewed above, further external adjustment in the industrial countries is expected this year, but the composition and extent of the adjustment is open

to question. In the United States and Japan, where adjustment has been the greatest in recent years, additional progress is likely to be much smaller and a modest widening of nominal imbalances cannot be excluded. Basic developments have brightened the adjustment prospects for Germany, but the very large existing imbalances suggest that substantial imbalances will remain.

However, developments in Europe could provide substantial impetus to the industrial country adjustment process over the next few years, with early signs perhaps beginning to emerge later this year. The unification of the two German economies is likely to be especially significant. The large population inflow into West Germany is already raising German domestic demand, due in part to the fiscal stimulus associated with higher transfers and infrastructure outlays. The additional demand can be met without undue inflationary consequences by diverting West German exports to domestic uses and by increasing imports. The net effect, over time, could thus be a significant reduction in the German surplus and a substantial increase in trade opportunities for non-German suppliers.

#### o Inflation

The increase in average inflation rates in the industrial countries in 1989 reflected the combined impact of several developments, including higher oil prices, excise tax increases in various countries, and generally higher capacity utilization rates. However, the bulk of the price runup occurred during the first half of the year, and for most countries inflation rates have tended to level off or subside since then.

A number of other factors appear likely to reinforce this more recent trend, which should push inflation moderately lower, on average, this year. Slower output and demand growth, coupled with the vigorous investment activity of the past few years, should ease pressures arising from higher capacity utilization and wage demands; and, the monetary and fiscal authorities are, for the most part, likely to continue to pursue a fairly restrictive course.

As a result, consumer price inflation is forecast to ease somewhat in each of the major industrial countries this year and to decline to slightly below 4 percent in the industrial countries in aggregate. Japan, Germany and France are expected to remain at the lower end of the G-7 group, with the United States and Canada in the middle, and Italy and the United Kingdom at the upper end.

## U.S. Balance of Payments Developments and Trends

### o Developments in 1989

The U.S. trade deficit, after declining markedly (by \$32 billion) to \$127 billion in 1988, fell further in 1989 to \$113.2 billion. The 1989 trade deficit was the lowest since 1984. The improvement occurred largely in the first half of the year as the pace of adjustment slowed over the course of 1989.

The continued, but slowed decline in the trade deficit reflected moderation in both export and import growth. In 1989, exports rose 13.4 percent in value (11.8 percent in volume), well below the corresponding performance in 1988 when export values had surged 27.6 percent (23.5 percent in volume). Most commodities shared in the rather general, small slowing of export value growth in the latter half of 1989. The largest changes occurred in foods, feeds and beverages, and in the typically "lumpy" completed civilian aircraft sector. Import growth also slowed -- from 8.8 percent (6.5 percent in volume) in 1988 to 6.4 percent (5.6 percent in volume) in 1989. (See Table 2.)

Two on-going phenomena affected 1989 imports, and are likely to continue to influence U.S. trade data. Petroleum imports were up by \$10.9 billion in value, to \$50.2 billion in 1989, their highest level since 1985. Oil prices rose 19 percent; quantities were up 7.75 percent to 8.06 million barrels per day, a figure not seen since 1979. Total automotive imports actually declined in 1989; those from Japan declined for the third consecutive year. Along with a softening of demand for autos generally, the increases in production and sales by foreign-owned auto producers in the United States were a major factor slowing automobile imports.

Geographically, the 1989 decline in the trade deficit was concentrated in Western Europe; that bilateral trade deficit dropped \$12.1 billion to \$3.6 billion. Deficits with other countries or regions fell by lesser amounts: the deficit with the newly industrialized countries of the Far East fell \$4.3 billion, to \$25 billion; that with Japan dropped \$2.9 billion, to \$49.7 billion; and that with Canada by \$2.4 billion to \$8.5 billion. The only major bilateral trade deficit to increase was that with OPEC which was up \$8.4 billion to \$17.1 billion.

The 1989 deficit on the balance on current account was also the lowest since 1984. It stood at \$105.9 billion, down \$20.6 billion from \$126.5 billion in 1988. For the year as a whole, the reduction in the trade deficit accounted for about two-thirds of the current account decline (some \$14 billion), while an improved position on services (see below) accounted for the remaining third (about \$7 billion).

The difference between the trade balance and the balance on current account largely reflects U.S. performance in services. The surplus on service transactions had peaked in 1981 at \$43.8 billion; until 1986, the balances generally indicate an underlying deterioration in these accounts. However, in 1988 and 1989, the services surpluses were \$15.4 and \$22 billion respectively. Last year, services trade shifted from approximate balance in the first half to a surplus of almost \$22 billion in the second. But that shift incorporated a swing from capital losses (some \$8 billion) in the first half to capital gains (also \$8 billion, for a total swing of \$16 billion) in the second. Those losses and gains reflect the effects of exchange rate changes on the conversion of U.S. foreign investors' foreign currency profits to dollars. Whether, therefore, the full-year figure for 1989 services trade suggests some reversal of the previous declining trend in that position remains uncertain.

The recorded net inflow of capital in 1989 was \$125.7 billion; unrecorded transactions (the statistical discrepancy) were \$34.9 billion. Major contributors to the gross inflow were a record amount of inward direct investment (\$61.3 billion, up from the previous high of \$58.4 in 1988), and foreign private purchases of U.S. securities (\$40.3 billion). On the outflows side in 1989, there was a substantial increase (\$25.3 billion) in U.S. official reserve assets, reflecting exchange market intervention activity; direct investment outflows rose strongly (by \$14.8 billion) to \$32.3 billion, while purchases of foreign securities nearly trebled to \$22.6 billion. (See Table 3.)

#### Prospects for 1990

As has been discussed, the U.S. trade deficit continued to decline in 1989, following its significant fall in 1988 from its 1987 peak. However, the pace of external adjustment slowed.

The outlook for 1990 is difficult to project with certainty. Most model-based forecasts project a modest widening in the U.S. current account deficit, although some project little change or even a slight improvement. These projections, however, are influenced by assumptions such as no policy changes, constant exchange rates, and unchanged structural characteristics of the U.S. and other major economies.

While conventional models provide very important information, they cannot capture the full range of factors at play in a dynamic world economy. For example, these models for the most part do not take into account the structural implications of recent developments in Eastern Europe and the prospective reunification of the two German economies. Also, they do not take into account the most recent exchange market developments, nor do they explain the strong role foreign direct investment may be playing in producing longer term and continuing adjustment of the current account. Furthermore, important developments that have taken place in the performance of the U.S. services account are less well understood than the merchandise trade accounts.

Despite our view that positive factors are at work in encouraging medium term external adjustment and that these factors are not captured by conventional models, it would appear that further improvement in the U.S. current account position in 1990 is likely at best to be very modest. Furthermore, the possibility of deterioration in the current account cannot be excluded.

PART III: FOREIGN EXCHANGE MARKET DEVELOPMENTSo Overview

Over the past six months, foreign exchange market activity was characterized by an appreciation of the German mark in late 1989 and a depreciation of the yen in early 1990.

Since the October 1989 report, the German mark has appreciated by 10 percent against the dollar, while the Japanese yen depreciated by 11 percent (as of April 10). Against the mark, the yen depreciated by 19 percent. Continental European currencies generally mirrored the movement of the mark against the dollar. The British pound ended the period little changed. Early in this period, the market perceived the G-7 as favoring a lower dollar and remained generally wary of dollar intervention sales. (See Table 4.)

The period since the October 1989 report can be subdivided into two parts. The first, from October 1989 to January 1990, was characterized by appreciation of the mark in the aftermath of the September 1989 G-7 Statement and in response to developments in Eastern Europe, including East Germany. The second, from January through mid-April, was highlighted by a sharp depreciation of the Japanese yen.

In market intervention, U.S. authorities sold \$2.5 billion between October and January.

October 1989 through January 1990: DM Appreciation

In the October-January period, the exchange value of the German mark rose in the aftermath of the September 1989 G-7 Statement, in response to changes in monetary policies in Germany and the United States, and in reaction to favorable perception of political changes occurring in Eastern Europe, notably the opening of the East German border and growing prospects for German unification, which were seen as providing attractive opportunities for real investment. During this time, the U.S. economy showed signs of slowing, and participants anticipated that changes in interest differentials would tend toward favoring placements in foreign currencies. However, foreign investor interest in German assets paused after the turn of the year, as uncertainties regarding German Economic and Monetary Union (GEMU) raised concerns about its potential inflationary risks. Such concerns moderated somewhat after the East German election in mid-March.

Foreign exchange markets were impressed by the forcefulness of the September 23, 1989, Statement of the G-7, which noted:

"The Ministers and Governors considered the rise in recent months of the dollar inconsistent with longer-run economic fundamentals. They agreed that a rise of the dollar above current levels or an excessive decline could adversely affect prospects for the world economy. In this context, they agreed to cooperate closely on exchange markets."

The G-7 monetary authorities intervened aggressively in the weeks immediately following the Statement.

Following the G-7 Statement and coordinated intervention, participants anticipated changes in official interest rates that would reinforce the desired trend in exchange rate movements. In the event, the Bundesbank raised its official rates by 1 percentage point (discount rate to 6 percent, Lombard rate to 8 percent) on October 5, 1989. The Bank of Japan raised its discount rate by 1/2 percentage point to 3-3/4 percent on October 11, 1989, and to 4-1/4 percent on December 25, 1989. The Federal Reserve eased reserve conditions in successive steps, with the result that the Fed funds rate fell from 9 percent at the end of September to 8-1/4 percent by the end of December.

With these changes in the relative stances of monetary policies, around mid-November, German interest rates neared U.S. interest rates, and this narrowing of interest rate differentials supported the mark's appreciation in late 1989. Meanwhile, indications of slowing U.S. economic activity fostered market expectations of moderating growth, diminished price pressures, and further declines in U.S. yields. (The October 13 stock market drop only sharpened market participants' focus on the perceived weakening in U.S. economic fundamentals, and by early December, the softness in the economy was viewed as confirmed by the U.S. November employment data.)

Elsewhere, economic activity remained more buoyant, and the West German economy in particular was thought to be operating near capacity. The opening of the East German border in early November was seen as likely to provide a further stimulus to growth and investment and, consequently to raise real yields on DM assets. German monetary officials welcomed the DM's rise against the dollar. Also, in late October, German monetary officials reportedly had begun expressing interest in a revaluation of the DM within the European Monetary System (EMS), and this contributed to the rise of the DM into early January, when the Italian lira was realigned in the EMS and Italy joined the narrower  $\pm 2\frac{1}{4}$  percent band.

Around mid-January, however, flows from dollars into marks stalled as the market grew increasingly concerned about the potential inflationary implications of GEMU. Meanwhile, flows into dollars were supported by some perceptions of a pickup in U.S. economic activity. The mark then began trading within a moderate range, slightly off its January highs, with its movements against the dollar at times influenced by developments in Eastern Europe and the Soviet Union.

February - April: Bearishness Toward the Yen

Between October and January, the yen traded in a fairly narrow range against the dollar. However, the yen had already declined considerably against the German mark in late 1989, as market concern about the inflation of Japanese asset values became evident. Substantial flows from Japan into German equities were registered at that time, although the effect on Japanese asset values was masked by the climb of Japanese stock prices to record levels by end-December.

Since mid-February, the yen has weakened substantially against other major currencies more generally, including the dollar, in response to to political uncertainties in Japan, market perceptions about the stance of official Japanese interest rate policy, and unease associated with the decline in Japanese equity markets. The decline of the yen became particularly pronounced in March. Also, during this period, U.S. interest rates rose and some participants took the view that U.S. economic growth might be "bottoming out."

Sentiment towards the yen in late January and early February was affected by political uncertainties ahead of the mid-February elections and the reluctance to tighten monetary policy further. The depreciation of the yen accelerated after the Japanese monetary authorities did not hike interest rates in the wake of the ruling Liberal Democratic Party's February 18 election victory and as Japanese equity markets declined. Market perceptions that an opportunity to raise official rates had been missed seemed to crystallize pessimism toward the yen. Subsequently, bearishness toward the yen increased rapidly in light of the market's concerns about Japanese economic policy and political conditions. Market perceptions of U.S.-Japan trade tensions were also bearish for the yen.

In this period, expressions of concern about yen depreciation by leading Japanese monetary officials, and about attendant risks to Japanese inflation and trade adjustment, were outweighed in the market's eyes by the absence of a change in the discount rate and the political uncertainties. Moreover, some Japanese monetary authorities repeatedly suggested that, barring a sharp drop of yen, they would rely on intervention rather than interest rates to support the yen. At the same time, however, the market came to believe increasingly that the yields on yen assets should be adjusted upward. A 1 percentage point discount rate hike (to 5-1/4 percent on March 20) came amid active buying of dollar assets that kept the yen, and Japanese stocks and bonds, under pressure throughout March. This hike had been largely discounted in advance, and the market looked for another hike in the near term.

In early March, President Bush and Prime Minister Kaifu reaffirmed cooperation on exchange rates. Later, market participants concluded that a meeting between U.S. Treasury Secretary Brady and Japanese Finance Minister Hashimoto did not produce commitments to support the yen. However, reports that the G-7 would meet on April 7 instilled caution into the markets.

The G-7 Ministers and Governors stated at their April 7 meeting that the decline of the yen against other currencies was having undesirable consequences for the global adjustment process. After appreciating slightly immediately following the G-7 announcement, the yen eased back to levels slightly below those prevailing prior to the meeting.

During the February through April period, the DM has traded narrowly against the dollar. Despite market concerns over the implications of GEMU in this period, participants felt GEMU would also support German growth. They also reacted favorably to the mid-March election outcomes in East Germany.

PART IV: ECONOMIC POLICY COORDINATION

In recent years, the major industrial countries have developed the G-7 economic policy coordination process to put in place the consistent and compatible economic policies necessary for sustained growth with low inflation, reduced external imbalances and greater stability of exchange rates. Under this process, substantial progress has been made in achieving the G-7's shared objectives.

The economic expansion has been sustained for eight consecutive years. Economic growth is slowing in several countries this year to more sustainable levels. However, overall growth prospects remain good. Inflation remains contained, reflecting the vigilance of authorities as well as the subsiding of temporary factors last year. External imbalances have been reduced, particularly in Japan and the United States.

These favorable developments have occurred in part due to the important role of the coordination process in promoting greater stability of the international monetary system in the face of significant changes, at times, in the world economy. Since the October report, further significant fundamental changes have taken place, including most notably the efforts of Eastern European countries to restructure political and economic life, and developments in global financial markets, particularly in Japan. Economic policy coordination, including cooperation in exchange markets, represents the most effective means of assuring that these profound changes now underway are managed in an orderly manner that contributes to the G-7's shared objectives.

Against this background, the G-7 Finance Ministers and Central Bank Governors met in Paris on April 7 to take stock of these changes and to review economic and financial developments in their countries. They noted that the major countries will need to continue their close cooperation on macroeconomic and structural policies and remain vigilant against current inflation rates. Both surplus and deficit countries have a shared responsibility to promote an open and growing world economy. Deficit countries, including the United States, should further reduce budget deficits and increase private savings. Surplus countries must contribute to external adjustment by promoting non-inflationary growth of domestic demand.

The depreciation of the Japanese yen has occurred in the context of a significant adjustment in Japanese equity prices as well as a correction in other Japanese asset values. The yen's weakness is a matter of concern, with undesirable consequences for the global adjustment process. The G-7 will keep these developments under review.

The restructuring of Eastern European economies away from central planning towards market-orientation will represent one of the key challenges of the 1990s. In this regard, the prospective unification of the German economies should contribute to improved global growth, to increased investment opportunities, and to a further reduction of external imbalances. Strong German domestic demand growth and a reduced current account surplus would be most welcome, especially in light of Germany's extremely large current account surplus and forecasts suggesting this surplus could widen further this year to roughly \$65 billion, equivalent to nearly 5 percent of GNP.

PART V: ASIAN NEWLY INDUSTRIALIZED ECONOMIES. (NIEs)Overview

Since the release of the October 1989 report, both Korea and Taiwan's exchange rate have depreciated against the dollar. The New Taiwan (NT) dollar was stable following the October report, depreciated in early March, and has since firmed slightly. On balance, NT dollar depreciation since October has totaled 2 percent. The Korean won has steadily depreciated since the October report by a total of 5 percent against the dollar. Over the longer term, however, the NT dollar has strengthened by 54 percent and the Korean won by 27 percent since the Plaza Agreement in September 1985. (See Table 5.)

The Treasury Department began discussions with the Asian NIEs in summer 1986 on their exchange rate and related policies against the backdrop of their rising external surpluses, particularly their surpluses with the United States. The U.S. merchandise trade deficit with the Asian NIEs as a group -- Korea, Taiwan, Hong Kong, and Singapore -- peaked in 1987 at \$34.1 billion and has declined a total of 29 percent since then. In 1989 alone, the trade deficit with the Asian NIEs fell \$3.9 billion to \$24.3 billion, a 14 percent decline from 1988. This compares to an 8 percent decline in the overall U.S. trade deficit from 1988 to 1989. As a proportion of the overall U.S. trade deficit, the deficit with the NIEs fell from 24 percent to 22 percent in the same period.

Under Section 3004 of the 1988 Trade Act, the Secretary of the Treasury is required to "consider whether countries manipulate the rate of exchange between their currency and the U.S. dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade." It was concluded in the October 1988 and April 1989 reports that both Taiwan and Korea "manipulated" their exchange rates, within the meaning of the legislation. Pursuant to Section 3004, the Treasury was required to initiate bilateral negotiations with Taiwan and Korea for the purpose of ensuring that these two economies regularly and promptly adjust the rate of exchange between their currencies and the U.S. dollar to permit effective balance of payments adjustment and to eliminate the unfair advantage. Subsequently to the October 1988 report, the Treasury Department initiated bilateral negotiations with both Taiwan and Korea on their exchange rate policies, as well as continuing talks with them on their associated macroeconomic and structural policies.

In October 1989, in view of the change in Taiwan's exchange rate system that had occurred during the course of the negotiations, and certain other factors, the Treasury concluded that there were no clear indications that Taiwan was "manipulating" its currency for competitive advantage within the

meaning of the legislation. We also indicated, however, that we would continue to monitor Taiwan's exchange rate policy closely, in view of the importance of such policy in furthering the adjustment of Taiwan's large external surpluses. Regarding Korea, the Treasury determined that there were indications of continued exchange rate "manipulation."

Following is a summary of the economic and exchange rate developments in Taiwan and Korea since our October 1989 report.

#### Taiwan

The appreciation of the NT dollar since 1985 has been a central element in the decline of Taiwan's external trade surpluses. In the past year, the NT dollar's appreciation has stalled, although other factors -- rising wages, inflationary pressures, and reduction of trade barriers -- have contributed to lowering the external surpluses. We expect this adjustment process to continue.

##### o Exchange Rate Developments

Since the October 1988 report, Taiwan's exchange rate has appreciated by 10 percent, more than that of any other major trading partner. Much of this appreciation occurred in a short period following the April 1989 report. The NT dollar thereupon fluctuated within a narrow range from May 1989 until early March of this year. At that time, the exchange rate depreciated by 1 percent. It has since rebounded slightly and stabilized.

The recent depreciation of the NT dollar was the result of a number of factors. Most importantly, there has been widespread attention in the local foreign exchange market to political uncertainties, especially prior to the March Presidential election. As such, large net capital outflows were reported in the first quarter of this year. The depreciation of the NT dollar was slowed by sizable sales of U.S. dollars by Taiwan's Central Bank.

There is some domestic pressure in Taiwan to depreciate the NT dollar. This view, however, ignores the fact that the recent depreciation was mostly due to speculators seizing on factors that may be short term. In this regard, the Central Bank has rightly noted that depreciation may not reflect Taiwan's still strong economic fundamentals and would have some adverse consequences. For one, the external surpluses, although declining, are still at unsustainably high levels. Real GNP growth also remains strong. Moreover, any potential benefit to exporters from devaluation would likely be negated by a fueling of inflation. Inflation, which has climbed primarily due to the build-up of excess liquidity generated by the large external surpluses, currently may pose the greatest threat to the economy. In addition, depreciation would send the wrong signals to producers by not encouraging the move toward higher value-added goods and weakening the role of domestic demand in economic growth.

o Trade and Economic Developments

In absolute terms, Taiwan's global current account surplus rose 9.5 percent in 1989 to \$11.2 billion. As a proportion of GNP, this surplus translated into a decline to 8 percent from 8.5 percent in 1988 and 18.1 percent in 1987. Taiwan's overall trade surplus (cif basis) increased by 27 percent to \$14 billion. Our bilateral trade deficit with Taiwan grew 3 percent last year to \$13 billion.

The above data include extraordinary purchases of \$2.5 billion of gold from the United States by Taiwan's Central Bank in 1988. If these one-time purchases are excluded, the trend in the external accounts continued downward in 1989. For example, the current account surplus fell 15 percent last year, if the 1988 gold purchases are excluded, and the U.S. bilateral trade deficit with Taiwan declined by 14 percent.

These surpluses, whether including or excluding the 1988 gold purchases, are excessively high.

The appreciation of the NT dollar from 1985 to 1989 has had an overall positive impact on the restructuring of the economy. Appreciation has encouraged the production of higher value-added goods and the movement of lower value-added production offshore. In addition, domestic demand has replaced exports as the main source of growth for the economy, with Taiwan's consumers benefiting from years of high savings. At the same time, unemployment, at 1.7 percent, is at an historical low.

Following years of very rapid growth, real GNP growth has been at a more sustainable level since 1988. Last year growth fell slightly to 7.2 percent. Inflation climbed from 1.3 percent in 1988 to 4.4 percent last year. Despite credit tightening measures and capital outflows, inflationary pressures continue to be a serious problem.

As a result of a rise in net capital outflow, Taiwan posted its first overall balance of payments deficit since 1977 last year. This led to a slight fall in foreign exchange reserves to \$73 billion, the world's second largest stock at the end of 1989.

In the first three months of this year, Taiwan's overall trade surplus declined by 35 percent over last year to \$1.8 billion. In February there was an overall trade deficit of \$300 million, although this owed much to special factors including imports delayed during end-January's Chinese New Year holiday and the delivery of a passenger airplane.

According to Taiwan's data, the trade surplus with the United States was down by 23 percent to \$1.9 billion in the first quarter of this year. Over the last three months for which U.S. data are available (November 1989 to January 1990),

our trade imbalance with Taiwan at \$3.4 billion is lower by 18 percent from the same period in the previous year and by 29 percent from the preceding three-month period. If this latest quarter were annualized, it would still lead to a large bilateral trade imbalance of \$11.3 billion.

o Exchange Rate System

Taiwan instituted a new exchange rate system at the time of the April 1989 report that significantly reduced the authorities' ability to manipulate the rate. The system allowed for most foreign exchange transactions to be freely determined. Thereafter, Taiwan took a number of measures to further liberalize the system and reduce capital controls.

Currently there is no evidence that the Central Bank has been substantially intervening directly in the market to gain competitive advantage. In fact, as noted earlier, the Central Bank has recently intervened in the market to control downward pressure on the NT dollar.

In the October 1989 report, a number of remaining impediments to liberalization of the Taiwanese financial system were identified. Since the October 1989 report, Taiwan has addressed several of these impediments. The ceiling on a foreign exchange bank's short (oversold) position in spot transactions was doubled in December. Taiwan also raised the limit on foreign liabilities of foreign exchange banks by 30 percent, effective March 10. This should permit banks to increase their foreign exchange activities.

Taiwan also established the Foreign Exchange Development Foundation in late February to operate the interbank foreign exchange market and the new U.S. dollar call market, which reduces the cost of short-term foreign exchange funds. Taiwanese authorities are developing a plan to introduce foreign exchange dealers into Taiwan in one or two years.

In another positive step, the limit on annual foreign exchange inflows was raised to \$1 million per entity in November. This limit, however, is still one-fifth the size of permissible capital outflows and impedes market forces. Given that there has been no surge in capital inflows and the NT dollar is stable, there is little justification for not soon raising the limit to at least the level of that for outflows.

Despite the recent relaxation of ceilings on "long" and "short" foreign exchange positions, their existence, plus the method of calculating the foreign exchange positions of a bank, effectively prevents a forward foreign exchange market from functioning. Contrary to international practice, Taiwan shifted from an accrual to a cash basis for calculating a bank's foreign exchange position in 1987 to discourage speculation on an

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appreciating NT dollar. On a cash basis, forward foreign exchange positions are not calculated. In addition, although the ceilings have not been reached they also discriminate against foreign banks since they are based on local assets. These assets are relatively small since Taiwan has restrictions on foreign banks' operations and branches.

#### O Assessment

We are encouraged by the fall -- albeit modest -- in Taiwan's external surpluses (adjusted for the 1988 gold purchases) over the past year and the continued liberalization of the exchange rate system, which more accurately reflects market forces. On balance, we are of the view, as expressed in the October 1989 report, that there is no evidence of direct exchange rate manipulation for competitive purposes.

We remain concerned, however, about the persistence of Taiwan's large external surpluses. Moreover, it can be argued that, despite the lack of evidence of direct exchange rate "manipulation," Taiwan's remaining exchange and capital controls -- recent liberalization notwithstanding -- constitute a mechanism for indirect "manipulation" by distorting supply and demand in the market. These factors underscore the importance of continued liberalization of remaining exchange and capital controls and, more generally, of exchange rate policy in contributing in the months ahead to the necessary further reduction of Taiwan's unsustainably large external surpluses.

#### Korea

The Korean won has depreciated about 6 percent in nominal terms against the U.S. dollar since the won's strongest point in April 1989, but remains some 27 percent stronger against the dollar than it was at the time of the Plaza Agreement in September 1985. In 1988, the won began to strengthen significantly against other G-7 currencies, particularly the yen, resulting in broad appreciation on a trade-weighted basis. These currency movements, aided by wage and other developments, contributed to a substantial decline in Korea's external surpluses in 1989. A further, but smaller, decline is possible this year.

Notwithstanding the decline in Korea's external surpluses in 1989, exchange rate policy continues to have an important role to play in Korea's external adjustment, including the needed further reduction of the trade imbalance between the United States and Korea. In this context, the steady depreciation of the won against the U.S. dollar since April 1989 raises some concerns. Introduction of the new "market average rate" system of exchange rate determination on March 2, 1990, is an important development. The eventual success of this system, however, depends on how it is implemented. In particular, liberalization of pervasive foreign exchange and capital controls is necessary to give greater scope to the forces of supply and demand in the exchange market.

Another development since the October 1989 report was the initiation of Financial Policy Talks between the Ministry of Finance and the Department of the Treasury. These talks provide a possible mechanism for addressing problems that U.S. banks and securities firms face in gaining access to the Korean financial services market. The initial round of these talks was held in late February, but much remains to be done before U.S. banks and securities firms can compete on an equal footing with their Korean counterparts.

#### o Exchange Market Developments

##### New Exchange Rate System (MAR)

The "market average rate" (MAR) system of exchange rate determination was introduced on March 2. Under this system, the won/dollar exchange rate at the beginning of each business day is equal to the weighted average rate of transactions in the inter-bank market on the preceding business day. Exchange rates between the won and third currencies are set in accordance with dollar rates in international currency markets.

During each business day, the won/dollar inter-bank rate is permitted to fluctuate within a band of +0.4 percent. Foreign exchange banks, including 53 foreign bank branches, are free to set customer rates within bands of +0.4 percent for won/dollar telegraphic transfer (TT) transactions and +0.8 percent for dollar-third currency TT transactions. A +1.5 percent band is established for cash customer transactions.

##### Recent Exchange Rate Movements

During the the first five weeks of operation of the MAR system:

- The won depreciated 1.8 percent against the U.S. dollar in nominal terms and 1 to 4-1/2 percent against most other G-7 currencies and the new Taiwan (NT) dollar.
- The won appreciated 3.6 percent against the yen, reflecting the weakness of the yen in international markets, offsetting on a trade-weighted basis most of the won's appreciation against the other currencies.
- Foreign banks accounted for the majority of transactions in the inter-bank market.
- The Bank of Korea (BOK) was not a direct participant in the market; and other government-owned banks accounted for a small share of inter-bank activity.

Since late April 1989, when the won reached its strongest point at 665/U.S. dollar, the won has depreciated nearly 6 percent against the U.S. dollar, 2-8 percent against the British pound and Canadian and NT dollars, and 15-16 percent against the German mark, French franc, and Italian lira. In the same period, however, the won has appreciated 13 percent against the yen, reflecting the generalized depreciation of the yen. Thus, on a trade-weighted basis, the won is virtually unchanged from its April 1989 level.

Given these developments, the won's cumulative nominal appreciation against the U.S. dollar since the Plaza Agreement in September 1985 has fallen to 27 percent. For the same period, the won's cumulative nominal appreciation now totals 6 percent against the Canadian dollar and 4 percent against the British pound. The won remains roughly 18-20 percent weaker in nominal terms than the yen, the French franc, Italian lira, and NT dollar, and 26 percent weaker than the German mark in nominal terms than it was in September 1985. Taking these various currency movements into account, the won is estimated to be roughly equal to its September 1985 level in trade-weighted terms.

#### Recent Changes in Foreign Exchange Controls

The government eased some foreign currency and capital controls as of March 1 to: allow certain Korean companies to purchase and hold up to \$10 million in foreign currencies; raise the limits on overseas investment by Korean securities firms from \$30 million to \$50 million and by Korean insurance and investment and trust companies from \$10 million to \$30 million; and allow Korean banks for the first time since 1987 to obtain up to \$2 billion of long-term capital from foreign banks or from the issuance of bonds in foreign markets.

#### o Trade and Economic Developments in 1989

##### GNP Growth

Economic performance in 1989 was weak by Korean standards, but strong by any other. Real GNP grew 6.7 percent. This compares with over 12 percent in each of the three previous years and was the lowest rate since 1981's 5.9 percent. Construction boomed (up 15.4 percent), but manufacturing was weak (up 3.7 percent) and agriculture declined (- 0.7 percent). On the expenditure side, consumption was up 9.5 percent, surpassing for the first time in several decades the rate of growth of GNP. Investment remained healthy, increasing 16.2 percent, including a 12.3-percent increase in plant and equipment. Inflation eased from 7.1 percent to 5.7 percent. Unemployment remained virtually unchanged at 2.6 percent.

Wages increased 21 percent on average for the 30 largest manufacturing companies through end-October, compared with increases of 12 percent and 20 percent in 1987 and 1988, respectively. Labor-management unrest lowered productivity gains to 7.1 percent in 1989, compared with 12 percent in 1987 and 1988, and resulted in production losses equal to an estimated 3.1 percent of GNP.

#### External Accounts

The current account surplus dropped 64 percent to \$5.1 billion (2.5 percent of GNP), compared with \$14.2 billion (8.4 percent of GNP) in 1988. The trade surplus also fell -- 61 percent to \$4.5 billion, compared with \$11.4 billion in 1988. Exports grew only 2.7 percent in value and declined 5.4 percent in volume. Footwear, toys, and especially automobiles accounted for most of the volume decline. Textiles, machinery and electronics, which account for more than half of exports, showed volume growth -- about 7 percent in the latter case. It is estimated that labor-management disputes were responsible for export losses of \$1.4 billion. Imports expanded 17.8 percent in value and 14.3 percent in volume. Consumer goods, however, accounted for only 14 percent of the total import growth, with raw materials (54 percent) and capital equipment (32 percent) accounting for the rest of the import growth.

According to U.S. customs data, the U.S. trade deficit with Korea has shown no significant growth since the first quarter of 1988. In 1989, it declined 30 percent to \$6.3 billion. This decline reflects a 19 percent increase in U.S. exports to Korea (compared with 39 percent in 1988) and a 3 percent drop in U.S. imports from Korea (compared with a 19 percent increase in 1988).

Korea's gross external debt declined to \$29.4 billion in 1989, equal to only 14 percent of GNP, compared with 28 percent of GNP as recently as 1987 and 52 percent of GNP in 1985. Total interest and amortization payments as a ratio of exports of goods and services declined from 14 percent in 1988 to only 10 percent in 1989. Excluding Korea's voluntary prepayments of principal, the 1989 debt service ratio was only 8 percent.

With the increase in international reserves to \$15.2 billion (3.2 months' import coverage) and in other foreign assets, Korea's net external debt declined to only \$3.0 billion by end-1989.

#### o Trade and Economic Developments in 1990

Preliminary BOK data indicate that Korea registered a \$646 million current account deficit in January-February 1990, compared with an \$888 million surplus in the same period in 1989. This included a \$722 million trade deficit for the two months (\$694 million trade surplus in January-February 1989).

Exports fell 12 percent in value in January but rose 6 percent in February, compared with the same months in 1989, while imports grew 6 percent and 23 percent, respectively. Further trade and current account deficits appear likely in March.

According to U.S. customs data, the U.S. bilateral trade deficit with Korea declined a further 33 percent to \$455 million in January 1990 (the latest month for which data are available). This was based on a 23 percent increase in U.S. exports to Korea to \$1.2 billion, while U.S. imports from Korea were unchanged at \$1.6 billion. For the latest three months (November 1989 to January 1990), the U.S. trade deficit with Korea stands 44 percent lower than it did in the same period in 1988-89.

Wage demands in the first quarter were less than half the level in the first quarter of 1989. The number of strikes is 79 percent lower so far this year. These developments should have a favorable impact on both growth and the external accounts. Indeed, production and export losses are only 3-4 percent of what they were in the first quarter of 1989. On the downside, inflation is creeping up to a 12-13 percent annual rate. The government is forecasting stronger economic performance in the second half of the year, and has not changed its projections for 6-7 percent real GNP growth and a \$2 billion current account surplus for 1990 as a whole. The government also expects that Korea will be a net international creditor by end-1990.

The recent merger of three leading political parties to create the new, ruling Democratic Liberal Party and the subsequent changes in leadership at the economic ministries have created public expectations in Korea that "growth-first" measures to stimulate the economy, and exports in particular, will be reemphasized. It is also expected that policies designed to improve social welfare and income and wealth distribution, while not neglected, will receive correspondingly less attention.

The new economic policy package announced on April 4, which builds on measures adopted in December 1989, bears out these expectations. To stimulate investment and exports, the package includes:

- Subsidized interest rates, higher credit ceilings, and tax incentives for investment and R&D in manufacturing and, particularly, exports; lower corporate income tax rates for manufacturing, as compared with services; streamlined government approval procedures for new manufacturing/export investments; and funds for technology development and training, especially aimed at small and medium-sized enterprises.

Other recent policy measures include:

- Indefinite postponement of introduction of the requirement to use real names in conducting financial transactions.
- Higher taxes, tighter credit, and possible economic and social sanctions to discourage "professional" or "habitual" real estate speculators.
- Tax reform to ease the burden on low-income wage earners along with other measures to increase incentives for construction of rental or low-income housing, employee education, and other benefit programs.
- Wage guidelines and controls and reductions in charges on public utilities.
- Tight restrictions on consumer credit, higher excise taxes, income tax assessments based on observed "standard of living" rather than reported income, and restraints on overseas travel expenditures (December 1989 policy package).

#### o Financial Policy Talks

Korea's impressive economic growth in recent years has not been matched by comparable development and liberalization of its financial system. Despite some steps to liberalize controls and provide national treatment to U.S. and other foreign financial institutions, the system remains characterized by pervasive government intervention in financial intermediation and significant constraints on the ability of U.S. and other foreign financial institutions to compete on an equal footing with Korean institutions.

With these problems in mind, the Treasury Department and the Korean Ministry of Finance initiated a new series of Financial Policy Talks in late February. These talks will provide a mechanism for addressing specific market access problems that U.S. banks and securities firms face in doing business in Korea and also allow a dialogue on the need for broader liberalization of Korea's financial, capital, and exchange markets.

In the first round, the Korean government gave positive signs of its willingness to address some specific issues, but necessary follow-up actions remain to be taken. We will be continuing these talks in the period ahead. The October 1990 report on International Economic and Exchange Rate Policy and the December 1990 report to the Congress on Foreign Treatment of U.S. Financial Institutions provide target dates for achieving substantial progress on these matters.

#### o Assessment

Korea has achieved a large and welcome reduction in its current account surplus, from 8.4 percent of GNP (\$14.2 billion) in 1988 to 2.5 percent of GNP (\$5.1 billion) in 1989. Also, the U.S. bilateral trade deficit with Korea declined by 30 percent in 1989 to \$6.3 billion. These imbalances, although sharply reduced, remain large and there is room for further reductions. In this regard, it is noteworthy that Korea's current account registered a deficit for the first two months of this year, although a surplus is expected for the year.

The won has depreciated 5 percent against the dollar since the October report, and by 1.8 percent since the introduction of the new exchange rate system on March 2. The depreciation against the dollar in the latter period, however, appears largely attributable to Korea's trade and current account deficits in the first two months of this year and capital outflows associated with concerns about the possible introduction of the "real name" financial system (now indefinitely postponed). Moreover, on a trade-weighted basis, the won's value has not significantly changed in this period. There is no evidence of the government conducting transactions in the inter-bank market for the purpose of directly influencing the exchange rate.

In view of these developments in Korea's external accounts and in its exchange markets, there are no clear indications at this time that the Korean won continues to be directly "manipulated," within the meaning of the legislation, by the authorities to gain unfair competitive advantage.

Nonetheless, exchange rate policy continues to have an important role to play in fostering external adjustment. Introduction of the "market average rate" system of exchange rate determination was a positive step forward. The real significance of this step, however, will depend on the government's willingness to ease the pervasive controls on capital flows and the types and amounts of permissible foreign currency transactions that give it effective tools for indirectly "manipulating" supply and demand in the currency market and, thus, the exchange rate itself. In this regard, the recent liberalization of controls on certain foreign currency transactions by large Korean corporations and on overseas investments of Korean financial institutions should increase pressure for the won to depreciate. Controls on capital inflows should be liberalized to offset this effect. It is not clear, however, that the net impact of the allowable \$2 billion in foreign borrowing by Korean banks will accomplish this. If the proceeds of these borrowings are on-lent in foreign currencies for the overseas expenses of Korean corporations, there may be little effect on the exchange rate.

Despite the lack of evidence of direct government "manipulation" of the exchange rate via transactions in the market, we remain concerned about the won's nominal depreciation against the U.S. dollar since April 1989 (although, in trade-weighted terms, there appears to be little change). By raising the cost of Korea's dollar-denominated imports, including its oil imports, depreciation will add to inflation, the increase in which is already a concern to policymakers. The resulting loss of real purchasing power could well lead to higher wage demands over the long-term, offsetting any beneficial short-term impact of depreciation on competitiveness. Moreover, as the United States is Korea's largest export market, depreciation against the dollar is likely to encourage the inefficient production of certain lines of exports in which Korea has already been losing competitiveness relative to lower wage-cost Asian competitors.

The recent policy measures signal greater government intervention in the economy and add to our concern. While we understand the government's concern about the sharpness of the declines in Korea's external surpluses in 1989, this reflects largely the long delay in beginning the adjustment process (the won did not begin to appreciate significantly against the dollar and, especially, the major non-dollar currencies until 1988). On balance, the new policies appear likely to delay the adjustment process. Aimed at increasing exports and suppressing domestic demand, the new measures may reinforce Korea's dependence upon exports as a source of growth and jeopardize the encouraging shift that appeared to have begun in 1989 toward greater reliance upon domestic demand as a source of growth.

In the period ahead, we will continue to monitor Korea's trade developments and the operation of the new exchange rate determination system closely. In the Financial Policy Talks, we will continue to encourage liberalization of Korea's financial, capital, and exchange markets as well as seek improved treatment for U.S. financial institutions.

PART VI: CONCLUSION

This report has provided an update of developments since October 1989, when the second annual report on international economic and exchange rate policies was submitted to Congress.

Global economic performance has remained favorable since the October 1989 report. The economic expansion in the industrial countries has been sustained for eight consecutive years. Economic growth is slowing in several countries, but to more sustainable levels. Strong investment is providing a major stimulus to the G-7 economies, and the prospects for overall growth remain good. Inflation remains contained, reflecting the vigilance of authorities and the subsiding of several temporary factors, last year, which placed upward pressures on inflation rates.

Substantial reductions in external imbalances have been achieved, particularly in Japan and the United States. The U.S. trade deficit fell further in 1989, by nearly \$14 billion to \$113 billion, and the current account deficit fell by some \$21 billion to \$106 billion. The pace of global external adjustment has slowed, however. Despite our view that positive factors are at work in encouraging medium term adjustment and that these factors are not captured by conventional models, further improvement in the U.S. current account position in 1990 is likely at best to be modest. Furthermore, the possibility of deterioration in the current account next year cannot be excluded.

The economic policy coordination process has contributed importantly to the favorable performance of the world economy in the current expansion. Continued economic policy coordination, including cooperation in exchange markets, will be essential in assuring that the profound changes underway in the world economy -- most notably, the changes in Eastern European political and economic life and developments in global financial markets -- are managed in an orderly manner that contributes to sustained growth, low inflation, and reduced external imbalances.

- Both surplus and deficit countries have a shared responsibility in this regard. Surplus countries must sustain non-inflationary growth of domestic demand. Deficit countries should further reduce budget deficits and increase private savings.
- All countries should promote appropriate structural reforms.

- The depreciation of the Japanese yen has occurred in the context of a significant adjustment in Japanese equity prices as well as a correction in other Japanese asset values. This depreciation is a matter of concern, with undesirable consequences for the adjustment process. The G-7 will keep these developments under review.
- The restructuring of Eastern European economies towards a market basis and the reunification of the German economies should contribute to improved global growth and to a reduction of external imbalances. This will be a most welcome development, especially in light of Germany's massive and growing external surpluses.

Other economies have a clear and complementary responsibility in promoting sustained non-inflationary world growth and adjustment of external imbalances. In the October 1988 and April 1989 reports on International Economic and Exchange Rate Policy, it was determined that Taiwan and Korea, within the meaning of Section 3004 of the Omnibus Trade and Competitiveness Act of 1988, were "manipulating" their exchange rates against the U.S. dollar to prevent effective balance of payments adjustment or gain unfair competitive advantage in international trade. In the October 1989 report, it was concluded that there were no clear indications Taiwan was "manipulating" its currency within the meaning of the legislation, but that there were indications of continued exchange rate "manipulation" by Korea.

Taiwan, last April, instituted an exchange rate system that allowed for most foreign exchange transactions to be freely determined. Since last October, a number of impediments to liberalization of the Taiwanese financial system have been addressed.

The appreciation of the NT dollar since 1985 has been a central element in the decline of Taiwan's external surpluses in recent years. Last year, however, Taiwan's global current account surplus rose by 9.5 percent to \$11.2 billion and as a share of GNP it declined slightly to 8 percent. The U.S. bilateral deficit with Taiwan also rose in 1989. The rise in Taiwan's external surpluses in 1989 in part reflected the effects of extraordinary purchases of \$2.5 billion of gold from the United States in 1988. Excluding these one-time purchases, Taiwan's current account surplus fell 15 percent and our bilateral deficit with Taiwan fell 14 percent. Nonetheless, these surpluses, whether including or excluding the 1988 gold purchases, remain excessively high.

Between May of 1989 and early March of this year, the NT dollar fluctuated narrowly against the U.S. dollar. Subsequently, it depreciated by 1 percent, before rebounding slightly. The decline reflected a number of factors, including significant capital outflows in response to continuing political uncertainties, and was resisted by the Central Bank. There is no evidence that the Central Bank has been intervening directly in the market to gain unfair competitive advantage. Moreover, the Central Bank has rightly noted that NT dollar depreciation does not reflect Taiwan's still strong economic fundamentals and would have some adverse consequences.

On balance, we remain of the view, as expressed in the October 1989 report, that there is no evidence of exchange rate "manipulation" by Taiwan. There is still reason, however, to be concerned about Taiwan's unsustainably large external surpluses. The adjustment process must continue. Liberalization of remaining exchange and capital controls and, more broadly, exchange rate adjustment need to play a role in this process. The Treasury Department will continue to monitor the situation carefully.

Korea has achieved a large and welcome reduction in its current account surplus, from 8.4 percent of GNP (\$14.2 billion) in 1988 to 2.5 percent of GNP (\$5.1 billion) in 1989. Also, the U.S. bilateral trade deficit with Korea declined by 30 percent in 1989 to \$6.3 billion. Korea's current account registered a deficit for the first two months of this year, although a surplus is expected for the year as a whole.

Korea introduced a new "market average rate" system of exchange rate determination on March 2. Since this system's introduction, there is no evidence that the government is conducting transactions in the inter-bank market in order to directly influence the exchange rate.

The won has depreciated 5 percent since the October 1989 report, and by 1.8 percent against the dollar since the introduction of the new exchange rate system. But the depreciation in the latter period appears largely attributable to Korea's trade and current account deficits in the first two months of this year and capital outflows associated with concerns about the possible introduction of the "real name" financial system (now indefinitely postponed). In trade-weighted terms, the won appears to have changed little since April 1989.

In view of these developments in Korea's external accounts and exchange market, there are no clear indications at this time that the Korean won continues to be "manipulated," within the meaning of the legislation, by the authorities to gain unfair competitive advantage.

Nonetheless, exchange rate policy continues to have an important role to play in fostering external adjustment. In particular, the government needs to allow supply and demand to function more freely in the exchange market. The government's pervasive controls on capital flows and the types and amounts of permissible foreign currency transactions give it effective tools for indirectly influencing supply and demand in the currency market and, thus, the exchange rate itself. Thus, these controls should be rapidly liberalized. The recent easing of controls on certain foreign currency transactions by large Korean corporations and on overseas investments of Korean financial institutions, however, could increase pressure for the won to depreciate. There should be a corresponding liberalization of controls on capital inflows to offset this effect.

Although there is a lack of evidence of direct government "manipulation" of the exchange rate, we remain concerned about the won's depreciation. Recent policy measures, aimed at increasing exports and suppressing domestic demand, add to our concerns. They are likely to delay the adjustment process, jeopardizing the encouraging shift that appeared to have begun in 1989 toward greater reliance upon domestic demand as a source of growth.

In the period ahead, we will continue to monitor Korea's trade developments and the operation of the new exchange rate determination system closely. In the Financial Policy Talks, we will continue to encourage liberalization of Korea's financial, capital, and exchange markets as well as seek improved treatment for U.S. financial institutions.

APPENDIXTABLES

1. Economic Performance of Major Industrial Countries
2. Summary of U.S. Trade and Current Account
3. Summary of U.S. Capital Account
4. Measurements of Dollar Movements Versus G-7 Currencies
5. Asian NIEs: Trade and Currency Changes

TABLE 1

Economic Performance of  
Major Industrial Countries

|         | <u>GNP 1/</u> |             |             | <u>Domestic Demand 1/</u> |             |             |
|---------|---------------|-------------|-------------|---------------------------|-------------|-------------|
|         | <u>1988</u>   | <u>1989</u> | <u>1990</u> | <u>1988</u>               | <u>1989</u> | <u>1990</u> |
| U.S.    | 4.4           | 3.0         | 2.4         | 3.3                       | 2.4         | 2.2         |
| Japan   | 5.7           | 4.9         | 4.6         | 7.6                       | 5.7         | 4.8         |
| Germany | 3.6           | 4.0         | 3.2         | 3.7                       | 2.8         | 3.1         |
| France  | 3.4           | 3.4         | 3.1         | 3.9                       | 3.2         | 3.2         |
| U.K.    | 4.5           | 2.3         | 1.3         | 7.4                       | 3.9         | 0.0         |
| Italy   | 4.2           | 3.2         | 3.0         | 4.3                       | 3.7         | 3.4         |
| Canada  | <u>5.0</u>    | <u>2.9</u>  | <u>1.6</u>  | <u>5.8</u>                | <u>5.2</u>  | <u>1.6</u>  |
| G-7 2/  | 4.5           | 3.4         | 2.8         | 4.6                       | 3.4         | 2.7         |

|         | <u>Inflation 3/</u> |             |             | <u>Current Account 4/</u> |             |             |
|---------|---------------------|-------------|-------------|---------------------------|-------------|-------------|
|         | <u>1988</u>         | <u>1989</u> | <u>1990</u> | <u>1988</u>               | <u>1989</u> | <u>1990</u> |
| U.S.    | 4.1                 | 4.8         | 4.0         | -2.6                      | -2.0        | -2.0        |
| Japan   | 0.7                 | 2.3         | 1.7         | 2.8                       | 2.0         | 2.0         |
| Germany | 1.3                 | 2.8         | 2.5         | 4.0                       | 4.4         | 4.9         |
| France  | 2.7                 | 3.5         | 3.1         | -0.4                      | -0.4        | -0.3        |
| U.K.    | 4.9                 | 7.9         | 7.2         | -3.1                      | -4.0        | -3.1        |
| Italy   | 5.0                 | 6.3         | 5.5         | -0.6                      | -1.1        | -1.0        |
| Canada  | <u>4.0</u>          | <u>5.1</u>  | <u>4.9</u>  | <u>-1.7</u>               | <u>-2.9</u> | <u>-2.7</u> |
| G-7 2/  | 3.3                 | 4.5         | 3.8         |                           |             |             |

\* Data for 1988 and 1989: national sources and International Monetary Fund. Data for 1990: For U.S. - Administration projections; for other countries - International Monetary Fund, World Economic Outlook (forthcoming).

1/ Annual average rates in real terms.

2/ Average of individual country rates, weighted by GNP.

3/ Consumer prices; annual average.

4/ Calculated as percent of GNP; negative indicates deficit.

Table 2

SUMMARY OF U.S. TRADE AND CURRENT ACCOUNT DEVELOPMENTS  
(\$ billion, seasonally adjusted)

| YEARS                   | 1988     |          | 1989     |          | 1989     |          |          |          |
|-------------------------|----------|----------|----------|----------|----------|----------|----------|----------|
|                         | 1987     | 1988     | 1988     | 1989     | Q1       | Q2       | Q3       | Q4       |
| Exports                 | 250.266  | 319.251  | 361.872  | 76.447   | 87.783   | 91.284   | 90.691   | 92.114   |
| Agricultural            | 29.547   | 38.142   | 41.433   | 9.021    | 10.777   | 10.879   | 9.683    | 10.099   |
| NonAgricultural         | 220.719  | 281.109  | 320.439  | 67.426   | 77.006   | 80.410   | 81.008   | 82.015   |
| Imports                 | -409.766 | -446.466 | -475.120 | -109.893 | -116.138 | -118.813 | -119.249 | -120.920 |
| Petroleum & Prods       | -42.944  | -39.309  | -50.250  | -10.068  | -10.845  | -13.424  | -13.018  | -12.963  |
| NonPetroleum            | -366.822 | -407.157 | -424.870 | -99.825  | -105.293 | -105.389 | -106.231 | -107.957 |
| TRADE BALANCE           | -159.500 | -127.215 | -113.248 | -33.446  | -28.355  | -27.529  | -28.558  | -28.806  |
| Net Investment Income   | 22.284   | 2.229    | 1.029    | 2.795    | -2.484   | -6.104   | 2.860    | 6.757    |
| Direct Investment       | 45.256   | 31.517   | 36.164   | 8.490    | 5.984    | 3.070    | 11.647   | 15.463   |
| (of which: Capital      |          |          |          |          |          |          |          |          |
| Gains/Losses on US      |          |          |          |          |          |          |          |          |
| Investments Abroad)     | 16.174   | -0.144   | -394     | 0.858    | -3.512   | -4.626   | 3.182    | 4.562    |
| Portfolio Investment    | -22.972  | -29.288  | -35.135  | -5.695   | -8.468   | -9.174   | -8.787   | -8.706   |
| Net Other Services      | 7.731    | 13.096   | 20.616   | 1.969    | 3.934    | 4.461    | 6.271    | 5.950    |
| Military                | -2.857   | -4.607   | -5.662   | -0.964   | -1.498   | -1.518   | -1.175   | -1.471   |
| Travel & Fares          | -6.252   | -1.923   | 1.176    | -1.006   | -0.229   | .095     | .766     | .544     |
| Other Transport         | -1.073   | -0.711   | -384     | -0.105   | -0.011   | .007     | -.249    | -.085    |
| Fee, Royals & Misc      | 17.913   | 20.337   | 25.486   | -0.116   | 5.718    | 5.877    | 6.929    | 6.962    |
| Unilat Transfers        | -14.213  | -14.657  | -14.277  | 5.125    | -3.487   | -2.829   | -3.485   | -4.476   |
| Remits & Pensions       | -4.063   | -4.280   | -4.029   | -3.376   | -1.147   | -.972    | -.975    | -.935    |
| Government Grants       | -10.150  | -10.377  | -10.248  | -1.088   | -1.340   | -1.857   | -2.510   | -3.541   |
| NET INVISIBLES          | 15.800   | .667     | 7.378    | -2.288   | -2.036   | -4.470   | 5.649    | 8.235    |
| CURRENT ACCOUNT BALANCE | -143.700 | -126.548 | -105.870 | -2.001   | -30.391  | -31.999  | -22.909  | -20.571  |

Source: SURVEY OF CURRENT BUSINESS, March 1990  
Details may not sum to totals due to rounding.

4/17/90

Table 3

SUMMARY OF U.S. CAPITAL FLOWS  
Inflows(+) Outflows (-) Billions

|                                           | YEARS   |         | 1988    |         |         |         | 1989    |         |         |         |
|-------------------------------------------|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|
|                                           | 1989    | 1988    | Q1      | Q2      | Q3      | Q4      | Q1      | Q2      | Q3      | Q4      |
| U.S. Reserve Assets<br>(incr(-) decr (+)) | -25.293 | -3.566  | 1.503   | 0.039   | -7.380  | 2.272   | -4.000  | -12.095 | -5.996  | -3.202  |
| Other U.S. Govt Assets                    | 1.036   | 2.999   | -1.673  | -0.829  | 2.001   | 3.499   | 0.869   | -2.254  | .543    | -.121   |
| Foreign Official Assets:                  |         |         |         |         |         |         |         |         |         |         |
| Industrial                                | 7.369   | 38.882  | 24.631  | 5.895   | -2.234  | 10.589  | 7.478   | -5.201  | 12.097  | -7.005  |
| OPEC                                      | -1.398  | 30.215  | 20.689  | 7.238   | -3.106  | 5.393   | 1.371   | -7.219  | 6.653   | -2.203  |
| Other                                     | 10.680  | -3.109  | -1.547  | -1.776  | -0.459  | 0.672   | 7.143   | .433    | 4.515   | -1.411  |
|                                           | -1.913  | 11.776  | 5.489   | 0.433   | 1.331   | 4.524   | -1.036  | 1.585   | .929    | -3.391  |
| Banks, net:                               |         |         |         |         |         |         |         |         |         |         |
| Claims                                    | 10.739  | 14.351  | -1.871  | 17.853  | -2.938  | 1.307   | -8.871  | 5.816   | 4.477   | 9.317   |
| Liabilities                               | -47.244 | -54.481 | 15.266  | -12.602 | -26.229 | -30.916 | -22.132 | 27.238  | -20.700 | -31.650 |
|                                           | 57.983  | 68.832  | -17.137 | 30.455  | 23.291  | 32.223  | 13.261  | -21.422 | 25.177  | 40.967  |
| Securities, net                           |         |         |         |         |         |         |         |         |         |         |
| Foreign Securities                        | 43.220  | 36.230  | 2.689   | 14.937  | 9.271   | 9.334   | 14.057  | 4.476   | 11.106  | 13.581  |
| U.S. Treas. Securities                    | -22.551 | -7.846  | -4.539  | 1.333   | -1.592  | -3.047  | -2.568  | -5.737  | -10.392 | -3.854  |
| Other U.S. Securities                     | 29.411  | 20.144  | 5.928   | 5.458   | 3.422   | 5.336   | 8.590   | 2.252   | 12.714  | 5.855   |
|                                           | 36.360  | 23.932  | 1.300   | 8.146   | 7.441   | 7.045   | 8.035   | 7.961   | 8.784   | 11.580  |
| U.S. Dir. Invest. Abroad                  | -28.290 | -15.017 | -5.476  | .612    | -4.899  | -5.254  | -4.962  | -6.613  | -8.642  | -8.073  |
| Reinvested Earnings                       | -21.437 | -15.170 | -3.901  | -2.721  | -4.489  | -4.058  | -3.856  | -3.619  | -9.575  | -4.387  |
| Equity & Inter-Co. Debt                   | -6.853  | .154    | -1.575  | 3.333   | -.409   | -1.196  | -1.106  | -2.994  | .933    | -3.686  |
| For. Dir. Invest. in U.S.                 |         |         |         |         |         |         |         |         |         |         |
| Reinvested earnings                       | 61.262  | 58.436  | 9.616   | 13.885  | 11.896  | 23.038  | 19.161  | 13.267  | 12.436  | 16.397  |
| Equity & Inter-Co. Debt                   | 3.363   | 6.560   | 1.774   | 1.357   | 2.083   | 1.347   | 0.208   | 1.807   | 1.189   | .159    |
|                                           | 57.898  | 51.875  | 7.842   | 12.528  | 9.814   | 21.692  | 18.953  | 11.460  | 11.247  | 16.238  |
| Other U.S. Corp., net                     | .921    | 4.874   | 1.500   | -6.502  | 2.605   | 7.271   | 4.687   | -3.315  | -.451   | -       |
| Claims                                    | .608    | -1.684  | -0.065  | -6.443  | 0.255   | 4.569   | 1.835   | -2.954  | 1.727   | -       |
| Liabilities                               | .313    | 6.558   | 1.565   | -0.059  | 2.350   | 2.702   | 2.852   | -.361   | -2.178  | -       |
| NET CAPITAL FLOWS                         | 70.964  | 137.189 | 30.919  | 45.891  | 8.324   | 52.056  | 28.419  | -3.919  | 25.570  | 20.894  |
| Statistical Discrepancy                   | 34.914  | -10.641 | -3.364  | -12.015 | 28.603  | -23.865 | -2.425  | 35.807  | 2.285   | -.753   |
| TOTAL                                     | 105.878 | 126.548 | 27.556  | 33.875  | 36.926  | 28.191  | 25.994  | 31.888  | 27.855  | 20.141  |

Sources: SURVEY OF CURRENT BUSINESS, March 1990.

Table 4

Measurements of Dollar Movements (for key dates)  
Versus G-7 Currencies  
Percent dollar appreciation (+) or depreciation (-)

As of April 10, 1990

| <u>Value of the<br/>Dollar in<br/>Terms of:</u> | <u>Since<br/>Dollar<br/>Peak<br/>26-Feb-85<br/>to date</u> | <u>Since<br/>Plaza<br/>Accord<br/>20-Sep-85<br/>to date</u> | <u>Dollar<br/>Lows<br/>31-Dec-87<br/>to date</u> | <u>Over<br/>Last Year<br/>10-Apr-89<br/>to date</u> | <u>Since<br/>Previous<br/>Report<br/>13-Oct-89<br/>to date</u> |
|-------------------------------------------------|------------------------------------------------------------|-------------------------------------------------------------|--------------------------------------------------|-----------------------------------------------------|----------------------------------------------------------------|
| Japanese yen                                    | -39.6                                                      | -34.8                                                       | +30.0                                            | +19.0                                               | +9.6                                                           |
| German mark                                     | -51.3                                                      | -41.4                                                       | +7.1                                             | -9.9                                                | -11.1                                                          |
| British sterling                                | -36.2                                                      | -17.2                                                       | +14.5                                            | +3.7                                                | -4.9                                                           |
| French franc                                    | -46.5                                                      | -35.5                                                       | +6.1                                             | -10.4                                               | -12.0                                                          |
| Italian lira                                    | -42.7                                                      | -36.0                                                       | +6.4                                             | -9.9                                                | -10.6                                                          |
| Canadian dollar                                 | -17.1                                                      | -15.6                                                       | -10.6                                            | -1.8                                                | -1.0                                                           |

Source: New York 9:00 a.m. exchange rates

TABLE 5  
ASIAN NIES: TRADE AND CURRENCY CHANGES

Cumulative Change against US\$ as of April 10, 1990

| from:       | (Plaza) | (Report) |         |          |        | Rate on 4/10/90 |
|-------------|---------|----------|---------|----------|--------|-----------------|
|             | 9/20/85 | end-86   | end-87  | 10/14/88 | end-89 |                 |
| HK\$        | 0.21%   | -0.11%   | -0.50%  | 0.19%    | 0.08%  | HK\$ 7.80       |
| Won         | 26.59%  | 21.89%   | 12.13%  | 0.52%    | -3.95% | W 706.60        |
| Singapore\$ | 17.16%  | 15.49%   | 6.15%   | 7.57%    | 1.12%  | S\$ 1.88        |
| NT\$        | 54.19%  | 35.08%   | 8.64%   | 9.97%    | -0.44% | NT\$ 26.28      |
| Yen         | 53.69%  | 1.29%    | -21.55% | -19.76%  | -8.83% | Y 157.56        |
| DM          | 72.20%  | 15.71%   | -4.73%  | 7.66%    | 0.90%  | DM 1.68         |

\* [-] signifies depreciation against the U.S. dollar.

U.S. Trade Balance with Asian NIEs [1]  
(U.S. \$ Billions)

|                 | 1985   | 1986   | 1987   | 1988   | 1989   |
|-----------------|--------|--------|--------|--------|--------|
|                 | ----   | ----   | ----   | ----   | ----   |
| Hong Kong       | -5.6   | -5.9   | -5.9   | -4.6   | -3.4   |
| Korea           | -4.1   | -6.4   | -8.9   | -8.9   | -6.3   |
| Singapore       | -0.8   | -1.3   | -2.1   | -2.2   | -1.6   |
| Taiwan          | -11.7  | -14.3  | -17.2  | -12.6  | -13.0  |
| -----           | ----   | ----   | ----   | ----   | ----   |
| TOTAL NIEs      | -22.1  | -27.8  | -34.1  | -28.2  | -24.3  |
|                 |        |        |        |        |        |
| Total U.S.      |        |        |        |        |        |
| Trade Balance   | -132.1 | -152.7 | -152.1 | -118.5 | -108.6 |
|                 |        |        |        |        |        |
| NIEs as % Total |        |        |        |        |        |
| U.S. Trade Bal. | 17%    | 18%    | 22%    | 24%    | 22%    |

[1] U.S. customs value data, not seasonally adjusted.

Totals may not equal sum of components due to rounding.

Senator SARBANES. Thank you very much, Mr. Secretary.

We have been joined by Senator Dixon, and I ask him for any statement he may have.

Senator Dixon. Mr. Chairman, thank you. I'll forego my statement for now to ask Mr. Mulford some questions I have.

Senator SARBANES. Mr. Secretary, aside from Taiwan and South Korea, which you address directly in the report, we see problems but I'm not quite certain they meet the statutory standards.

Are there any other countries that you are concerned about that might be engaged in currency manipulation?

Secretary MULFORD. We don't have other countries that we feel engage in currency manipulation to accomplish an unfair trade advantage.

There are countries, however, whose currency systems need to be improved and we do keep those in mind. We have not engaged in the kind of in depth negotiation with countries that we have with Korea and Taiwan.

Senator SARBANES. Well, the 1990 report on Foreign Trade Barriers by the Office of the U.S. Trade Representative specifically cites the People's Republic of China using foreign exchange controls. That report states that, quote:

"China administratively controls foreign exchange allocations and uses these controls as trade policy tools to restrict imports."

The report also cites the PRC for providing as an export incentive internal exchange rates which give exporters a 50-70 percent premium.

First of all, what is your view of these findings of the trade representative?

Secretary MULFORD. We have looked at China's situation and the situation there is one where we think the system could be greatly improved. In fact, the judgment about the currency is that it is over-valued today instead of under-valued in trade terms.

They do have an excessive amount of controls; whether or not the specific points you referred to are valid or not, I would have to look into. I can't really give you a fair analysis, an appreciation of those particular points.

Senator SARBANES. Well, the figures we have show that the PRC won has depreciated significantly against the dollar since 1985 while most other countries have appreciated.

According to the Federal Reserve's Monthly Bulletin, in 1985, the exchange rate was 2.9/1. In 1986, it rose to 3.4/1. In 1987, at 3.7/1, where it remained in 1988 and 1989. Yet, in the first 2 months of this year rose abruptly to 4.7/1, an increase of over 25 percent above the level of 1988-89. At the same time, this merchandise trade balance of the PRC has widened very significantly. In fact, it went from \$3.47 billion in 1988 to \$6.18 billion in 1989.

Looking at your report—not your statement, but the report—I don't even see the PRC included in any tables. I don't see any focus on it at all.

I wonder, in light of these currency shifts that I've mentioned and the shift in trade balance, whether they ought not be the focus of some of your attention.

Secretary MULFORD. I think your point, Mr. Chairman, is very well-taken. I think the explanation as to why we haven't made a

more detailed examination before this of China is that China is in overall deficit in its trade account with the world. And the law directs us to initiate action on the question of whether or not there's manipulation of exchange rates for unfair trade advantage with countries that have a material global current account surplus.

So we've tended to focus on those countries in particular. But, as you've made these remarks this morning, we would be happy to look into this and send you a written statement on China as a supplement to the report, if that's helpful.

Senator SARBANES. That would be very helpful, I think, because they have almost doubled their trade balance with the United States between 1988 and 1989, \$3.47 billion to \$6.18 billion.

And then we have this marked shift in the currency that's taken place right at the beginning. I mean, that's an extraordinary development.

Do you have any explanation for it?

Secretary MULFORD. Well, you are correct that there's been a very sharp change in our bilateral trade account with China, although China has an overall deficit in 1989 of \$1.9 billion. So they were still in trade deficit.

And you're quite right though that our bilateral situations have deteriorated sharply.

Senator SARBANES. What about this shift in the currency relationship, this jump from 3.71 to 4.71 in the first part of this year? That's a 25 percent shift.

Secretary MULFORD. That's correct. But we have to bear in mind that China devalued its currency by 21 percent against the dollar in December 1989. There's been substantial recovery. It is still regarded as a currency that is over-valued as opposed to one that is devalued or that has been depreciated to gain trade advantage.

My suggestion would be that we should focus on this and give you an intelligent and reasoned statement.

Senator SARBANES. Fine.

Senator Heinz.

Senator HEINZ. Mr. Secretary, I'm a little unclear about the conclusion you come to with respect to Japan. You do point out that their currency has been depreciating. You indicate that there are problems with the openness of their capital markets. You indicate that we have a bilateral trade deficit, and they enjoy a worldwide considerable trade surplus.

What is it that you propose to do? Because, as I understand the law, those are all the signs that you hope not to find.

Secretary MULFORD. Are you referring to this law on the question of currency manipulation?

Senator HEINZ. Yes.

Secretary MULFORD. Well, we don't have the view, nor have we had the view in the past when we have looked into the matter in some detail back in the middle 1980's, that Japan manipulates its currency for the purpose of an unfair trade advantage.

That is not a case that we have ever been able to make in our examination of Japan, and we don't think that's a valid point on the Japanese system.

They do not manipulate their currency for trade advantage.

Senator HEINZ. What are the characteristics of their capital market that restrict the free flow of international financial activities?

Secretary MULFORD. I think that we certainly do have the view that Japan needs to further liberalize its domestic capital markets and to improve access to those markets to foreign firms.

We also favor internationalizing the yen. We have accomplished some of that. That is to say, causing the yen to be more widely used internationally so that it has a value that more clearly reflects the underlying economic fundamentals in Japan.

I think a lot has been accomplished there. But I think our chief problem, as you know from our past conversations on this, is that the domestic deregulation process is still only about halfway completed in Japan. This creates a situation in Japan which causes a number of structural problems that make the adjustment of their surplus more difficult to accomplish, in our opinion.

But we do not list among those structural problems the manipulation of their currency in exchange markets.

Senator HEINZ. Just so I'm clear, if the result of keeping capital markets closed is to make a currency weak, irrespective of what you or I may think is the intention, but if that's the result, is that, in effect, a means of achieving or maintaining a favorable trade position?

Secretary MULFORD. If that could be sustained on a steady basis, I suppose you could make that argument. But I think it's worth pointing out that one of the causes of the recent depreciation of the yen in my opinion is that, when the Japanese and other investors began to liquidate assets in Japan—long-term assets, such as stocks, property, et cetera—they cannot invest these proceeds effectively in the short-term market, because Japan has not really created an effective short-term money market with competitive instruments and rates.

Therefore, when that liquidity is created, it tends to leave the country. That, of course, depresses the value of the currency even though the other economic fundamentals in Japan continue to look quite good. And I think that's had something to do with the depreciation of the yen.

But that is probably something that is temporary and related to these very large flows that have resulted from the liquidation of assets that, over the past couple of years, appreciated very substantially in Japan.

So I don't really think you could come to the conclusion that that kind of recent currency movement is an unfair trade practice.

Senator HEINZ. Let me ask you about the events in Eastern Europe. A number of us on the Banking Committee just returned from Eastern Europe on Monday. And we had the opportunity to visit Berlin and East Germany.

And the issue of the convertibility of the ostmark is clearly an issue with which both German governments are preoccupied.

What effect do you see of currency union between what is now East and West Germany? And under what circumstances would you anticipate possibly adverse effects on the world economy, if any?

Secretary MULFORD. I think, as we approach that Unification, the terms of the Unification, the economic and financial terms will be very, very important.

If you assume unification that will be managed properly from an economic and financial standpoint, then I think the results could be very positive from the standpoint of global developments.

Senator HEINZ. Would you care to tell us what "properly" means? They seem to have a little difficulty in defining that themselves. Is that one for one?

Secretary MULFORD. I think it involves much more than just the specific rate of conversion, though that's very important. And I would not wish to venture an opinion on what those current currency exchange rates should be. By "proper," I mean that values are appropriately recognized. Different levels of productivity are appropriately recognized. That the response in West Germany to managing the situation on the fiscal side and on the monetary side is appropriate.

And there's every reason to believe that the German authorities will manage the process appropriately. They have a very good record of financial management.

Senator HEINZ. I think that's quite true.

My time has expired. Let me just make the observation that they're attempting something that's never been done. They're taking a centrally-planned, deeply-depressed, tremendously-ancient economic structure, and they're attempting to bring it into the world economic system overnight.

We all wish them well. We hope they can achieve it. There are clearly a lot of problems they're going to have to overcome, not the least of which is an inflationary problem that could well spread beyond their borders.

If they choose to provide a lot of purchasing power to the East Germans, it will have an effect not only on West German inflation, or German inflation, but inflation tends to spread. And I would think that that would be one concern that not only the Germans have, but that we should have.

Thank you, Mr. Chairman.

Senator SARBANES. Senator Dixon.

Senator DIXON. Thank you, Mr. Chairman.

Mr. Secretary, I've had an opportunity to take a look at your report. It seems to be a kind of good news/bad news report.

The good news is that our trade deficit and our balance of payments deficit is showing some improvement.

The bad news is that the yen has fallen about 20 percent against the dollar. And that fact, it seems to me, Mr. Secretary, jeopardizes our prospects for continued improvement on the trade front.

I recently heard from the largest exporter in my State, Caterpillar. They tell me that all their efforts to cut their costs to improve their international competitiveness have been wiped out by the relative cost advantage this latest currency move has given their chief international competitor, Komatsu.

Obviously, I know exchange rates respond to a number of factors. But I must confess, Mr. Secretary, that I somehow wonder how it's possible for the dollar to be rising given the size of our overall

trade and balance of payments deficit and the size of our bilateral deficit in these areas with Japan.

As you know, Congress has been trying to improve our export performance, but if the yen keeps falling against the dollar, I don't see how our trade deficit with Japan can be reduced. And I guess I'd like to ask you two questions:

One, how can we reduce that deficit, particularly with a country like Japan, in view of the situation with respect to the falling value of the yen against the dollar. Number two, how can our major exporters, like Caterpillar, compete effectively in these circumstances?

Secretary MULFORD. Let me just make one observation about the movement of exchange rates that you referred to.

It's correct the yen has depreciated against the dollar. And we have said in the last communique that that is an undesirable development.

I said this morning in my testimony that the depreciation of the yen together with Japan's relatively closed markets is not a sustainable situation over time.

So I made a very clear statement on that point. And I share many of your views. However, since last September, which was the time of the last G-7 Ministerial meeting, during which this depreciation, much of it, has taken place of the yen, it is important to note that the trade-weighted value of the dollar in that period is still 8 percent below where it was last September.

So that, in global terms, we are that much more competitive.

Now, as you point out, that may not address the bilateral balance with Japan, which is a rather special problem. In recent years there has been less improvement in our bilateral balance with Japan than there has been in the other areas of our trade relationship, despite this currency adjustment. What that says to me is that currency adjustment is not the only tool.

And, in particular with Japan, it is important to pursue other avenues to open Japan and change it structurally to get better access to markets. By simply depreciating the dollar against the yen, that isn't going to do it. It is obviously not helpful to have it moving in the wrong way, but it isn't the sole instrument that we have to look to.

We have to concentrate on structural impediments, talks of the kind we've been having, trade talks, and continuing efforts to open Japan. And also continuing efforts to liberalize their financial markets.

Personally, it seems to me that the yen has been to some extent influenced by these very large flows I mentioned earlier. You may have noticed in the last couple of days that the stock market seems to have turned around a bit in Japan and, with it, the currency has turned around reflecting, it seems to me, the linkage there.

So the fundamentals of Japan would suggest that the yen should be stronger than it is. And I can only hope this is temporary.

Senator DIXON. If I can pursue that, with the greatest respect—if I may pursue in the most respectful manner the points you have made—no one would quarrel with any of the points you have made, particularly those of us who work on these committees and have occasion to get modestly more expertise than the average

person who has certainly less than you have, and I do not mean to be quarrelsome when I say this, but it is sort of like the argument about interest rates. We talk about when interest rates go up and interest rates go down. About all people understand out there when they are trying to get a loan is that it is hard to get one when rates are high, and easy when rates are low, and a lot of things depend upon that.

But getting back to the basic point here, I do sense in your answer a concern about this situation with respect to the yen vis-à-vis the dollar. No matter what kind of explanation you have for the existence of that in the marketplace, it exists for any appreciable period of time. Obviously, real people who work for Caterpillar Tractor and Caterpillar itself, a major employer in my State and one of the very biggest, and other exporters all over the country, have a real problem in connection with the disadvantage they experience.

As I pointed out in my question, here is a company that has spent a great deal to involve all kinds of efforts in cost cutting, and they are finding a disadvantage in the global marketplace against their major competitor in the world, Komatsu, because of this declining rate of the yen against the dollar.

So I presume we do have a genuine concern about doing something about it.

Secretary MULFORD. We indicated in the communique that we issued in Paris the fact that the depreciation of the yen was undesirable. I think we should keep it in perspective, though, Senator. That is to say that the yen at its present level is around where it was at the time of the Louvre Agreement. It has, in the intervening period, of course been stronger but it is not a very substantially different rate than it was at the time of the Plaza.

So what I think we should say there I think is, yes, we are concerned about the movement recently. We have expressed that view. I said this morning that the combination of a weakening yen and a closed Japan are simply not a sustainable position. If Japan were to reintroduce export-led growth, for example, as a result of the depreciation of the currency, that over the long run would be a very serious problem for Japan, particularly.

So it is a problem that we are very much aware of, but I think one has to try to keep it in perspective and take that longish term view of it.

Senator DIXON. I thank you very much, and I thank the Chair.

Senator SARBANES. When is the next G-7 meeting?

Secretary MULFORD. The next G-7 meeting is going to be held at the time of the Interim Aid Development Committee meetings here in Washington in early May.

Senator SARBANES. Is the issue that Senator Dixon has been asking about, do you expect that to be a leading item on the agenda of that G-7 meeting?

Secretary MULFORD. Yes, I do, because it was a leading item at the last meeting. What the Senator did not say, but I am sure knows, is that the depreciation of the yen has been far greater against the European currencies than it has been against the dollar. Therefore, they are also concerned in Europe in particular

about what this may mean for penetration into the European markets, because the decline is very substantially larger there.

Senator SARBANES. There has been some criticism of the G-7 meeting, that it really did not do anything seriously in terms of coordination at its last meeting. It made some of these statements about concerns, but that no coordinated action has been taken to address anything, and the problem continues to be before us.

Obviously if the yen stays weak it will promote for the Japanese a larger trade surplus with the United States I am struck by how the figures I have on—this is merchandise—the trade balance with Japan, the United States and Japan, is for us minus-\$33 billion in 1984, minus-\$46 billion in 1985, minus-\$55 billion in 1986, minus-\$56 billion in 1987, minus-\$52 billion in 1988, and minus-\$49 billion in 1989.

Now there has been a slight improvement, but if you look at it over time you go from minus-\$33 billion in 1984 to minus-\$49 billion in 1989, which is an increase of 50 percent over a 5-year period in the trade imbalance.

Secretary MULFORD. Maybe I could make two responses to that, Mr. Chairman.

Senator SARBANES. And Senator Dixon already has in effect the direct story from an American producer who is now confronting the impact on their efforts that is just occurring. Until you have got this currency run up, they felt they were in a position to compete. Now they see this happening and it is just cutting the legs out from under them—cutting the tracks out from under the tractor I guess would be more accurate.

Secretary MULFORD. Well, I would make two points about the figures that you read off, Mr. Chairman.

One is that during that period there was a lot of successful policy coordination accomplished in the sense that domestic demand for example in Japan, starting in 1987, was very substantially strengthened. Japan has been pulling in more imports, which is very, very desirable.

There has also been a substantial adjustment of currencies accomplished since the time of Plaza.

Our own situation has been that we have greatly improved our export capability. Our export figures have been up sharply each of the last 2 years, and our trade balance has been improving. Clearly things are moving in the right direction.

What it tells me is that to look only at the currency does not really provide the answer about reducing that large imbalance with Japan, although it makes a contribution. But we cannot just focus on currency. We have to focus on the other elements that make the adjustment of that bilateral imbalance so difficult. Those, it seems, are very heavily influenced by structural problems.

Senator SARBANES. Mr. Secretary, let me just interrupt you there, because I have here a Wall Street Journal article of April the 6th: "Currency Squeeze: Caterpillar Sees Gains in Efficiency Imperiled by Strength of Dollar." And then they say that the executives at Caterpillar are concerned about a force beyond their control undermining their efficiency drive. This is after they have talked about measures to increase their efficiency:

"The weakening Japanese yen over the past 16 months, the dollar has climbed 30 percent against the yen, making Japanese goods comparably less expensive in the United States and third-country markets, and giving Caterpillar's rivals a substantial competitive edge."

Indeed, the differences in the exchange rates alone has slashed Komatsu's costs—that is one of the Japanese competitors—

Senator DIXON. Tell me about it.

Senator SARBANES. Komatsu's costs by a greater percentage than the reductions Caterpillar anticipates from its entire modernization program.

Now a 30 percent shift in these exchange rate values? I mean how is a producer going to be able to deal with that situation?

Secretary MULFORD. Mr. Chairman, let me just give you the figures that are in the report. I do not know how those tally with those in the article, but over the period since our October 1989 report until now, the dollar has declined 10 percent against the deutschemark, and it has risen by 11 percent against the yen. As I said, since last September the trade-weighted value of the dollar is still 8 percent below where it was last September.

Now I recognize that it may be difficult for a particular company which competes directly. Its major competitor is in Japan, and there have been adjustments in exchange rates with Europe that are even more advantageous for Japan. I can see that as a very substantial problem for Caterpillar Tractor. I am not diminishing that problem, nor am I saying that it is unimportant in the overall situation, but the global situation is not as negative as the bilateral exchange rate figure between the United States and Japan suggests.

One could argue that as you look forward, the effect on imbalances between us may be less dramatic than it might have been a few years ago because of the very large direct investment Japan has made in the United States, which is to some extent replacing imports from Japan—cars, for example.

So it is very hard to know how to read the future impact of these figures. It is clear that the appreciation of the deutschemark and the European currencies against the dollar has varied substantially in recent months, together with the potential for stronger growth in Germany and an adjustment in Germany, and stronger growth throughout the whole of Europe as a result of the events that are going on now in Europe should suggest that our overall position might be offset very considerably by gains in Europe.

So I do not think it is a universally negative point.

Senator SARBANES. Let me ask you this question right on that point. Would you regard it as a stable situation if we had overall balance—which we are very far away from in our trade arrangements—overall balance, but it was achieved by having very large surpluses with some countries, and extremely large deficits with others, even though when netted out it put us into sort of a balanced position? Would you look at that and say, well, that's fine? Or, do very large surpluses and very large deficits in and of themselves with particular trading partners pose serious stability problems, as you see them?

Secretary MULFORD. I agree with you that they pose serious problems. I would not say "stability problems," necessarily, but they could be very serious problems.

I have already said that in the case of Japan. I made a very strong statement about that. I said that the present situation is not a sustainable one.

Senator SARBANES. With whom do we have our next largest deficit after Japan? Japan was about \$50 billion in 1989. Is that correct?

Secretary MULFORD. Yes, it was in 1989, \$49.7 billion. Our next-largest deficit was with all the NIE's combined, \$24.9 billion. With Germany itself, \$8.3 billion.

Senator SARBANES. You are putting in who, now? Korea, Taiwan, Hong Kong, and Singapore?

Secretary MULFORD. Yes.

Senator SARBANES. With Taiwan at \$13 billion, I take it? Just by countries, they would be next. Is that correct?

Senator DIXON. I think Korea is about \$7 billion, is it not?

Senator SARBANES. Korea is \$6.5 billion.

Secretary MULFORD. By country, yes, they would be next. Taiwan would be next.

Senator SARBANES. So it is Japan with \$50 billion, Taiwan at \$13 billion—

Secretary MULFORD. Then we go to Canada at \$8.5; West Germany at \$8.3; Korea is \$6.7. We had a \$17 billion deficit in 1989 with the OPEC countries, again a special situation but they are grouped together as well.

Senator SARBANES. It seems to me that those imbalances with some of those countries are just in and of themselves so excessive that you cannot run an international economic system over time and continue to sustain these very large imbalances.

Secretary MULFORD. I would agree with that, but I would also say that if you go back to 1987. For example, let me just give you a quick review. In 1987 within our deficit with Germany was \$15.4 billion. It is now \$8.3 billion. Japan was a deficit \$66.9 billion; it is now \$49.7 billion. Canada was a deficit of \$11.6; it is now \$8.5 billion. All the NIE's together were a deficit of \$34.8 billion, and are now \$24.9 billion. Latin America was a deficit of \$12 billion; it is now minus \$8.7 billion. And if you take the EC as a whole—

Senator SARBANES. Mr. Secretary, could you take the percentages and tell me, compare the percentage reduction in the trade deficit with Japan with the other countries you were giving me, or the other regions you were giving me?

Secretary MULFORD. Yes, I can. Our reduction—I forgot to read the best performance, so let me just make that one. That is against the whole of the EC where the deficit is down. We have improved by 97 percent. In the case of Germany, we have improved by 46 percent. Japan is down 13 percent—clearly inadequate.

Senator SARBANES. What about the other ones you gave me?

Secretary MULFORD. Canada down 27 percent. All NIE's down 29 percent. OPEC up 28 percent. Latin America, down 29 percent. Overall, it is down 29 percent in our trade balance.

Senator SARBANES. So all EC is 96 percent down? Germany is 46 percent down? Canada, the NIC's and Latin America, was it, were all 27 to 29 percent down, in that range?

Secretary MULFORD. That's right. Yes, sir.

Senator SARBANES. Japan is 13 percent. Now that is an incredible contrast.

Secretary MULFORD. Yes, and also a very large portion of our overall trade. So it is a very serious problem. My point is that these things take time to change. The policy coordination process has produced I think rather substantial results.

One of the things we have to bear in mind, although this is a point that sometimes can be attacked, I think it is important to bear in mind where we would have been if we hadn't begun in 1985 to take the measures we did and coordinate policies. Because if you project what would have happened to our external imbalances without these efforts, they would have been very much worse than they are today.

So the improvement might not look too great, but if you measure it against where you would have been——

Senator SARBANES. If you do that, we would have turned out the lights and locked the door. If you project in those terms, that would have been absolute disaster, would it not?

Secretary MULFORD. Yes, I think it would have.

Senator SARBANES. Let me put this to you. Well——

Senator DIXON. I wanted to ask one more question. I was very supportive of the direction the Chair was moving in, and I did not want to interrupt.

Senator SARBANES. Well, let me put this question to you. I have a feeling here, and I sense that perhaps when you were talking in your report about the currency in Taiwan and Korea, that perhaps just enough is being done to get on the side of the line where you cannot say there is a manipulation, but not enough to really say, well, this currency is working off of market forces and there is not really something working here to gain a trade advantage.

Do you have an uneasy feeling in that regard?

Secretary MULFORD. I always have an uneasy feeling in any system like this, having had long experience with some of these countries, that they are doing as little as they possibly can to satisfy a particular problem. But I think it is not supported by the facts, to make the arguments that you have made.

Very briefly, for example, in Taiwan they have introduced a much more progressive market-oriented exchange rate system. They are clearly now much less manipulative in a direct sense than they were before, yet the improvement in their trade surplus has been relatively more modest.

In Korea where the progress has been much slower and they have only recently introduced an improved system which is much less market-oriented than Taiwan's, there has been an enormous adjustment of their surplus clearly affected by the wider range of other forces such as labor relations and a variety of other things.

Again, the exchange rate and the regime is not the whole story here. You cannot really make the argument you have made, because the overall problem is not so easily managed by them, even

though they maybe would like to be able to do it that way; I do not think they actually can.

Senator DIXON. Well, Mr. Chairman, I thank you for pursuing that line. It is very helpful to the concerns this Senator has. I just wanted to make a statement, if I could, Mr. Secretary, which is in no way critical of anything at all that you have said.

Caterpillar is such a good example I think of a major American concern that has had these experiences in the international marketplace. It is one of the very largest employers in my State and is a highly respected and well-regarded business house that has been internationally competitive for generations.

There is an old saying in politics: You know, how does it play in Peoria? Since I have been on this committee, I would like to tell you two experiences Caterpillar has had that this Senator has experienced with some distress.

The first was when the Soviets were building the pipeline, President Reagan prevented Caterpillar from selling Caterpillar tractors to the Soviets for cash-American at that time, and of course they were not able to do so. Komatsu then sold all the tractors to the Soviet Union. Mr. Secretary, before that time I had never seen a Komatsu tractor in my life. Now you can see Komatsu tractors in Peoria, Illinois.

Now since that time, Caterpillar fought back. It made all kinds of economic reforms in its operation. It cut everything to the bone, became lean and mean, and got competitive again and went out into the world market and fought to regain its dominant position. It now tells me that this situation with respect to the yen vis-a-vis the dollar is causing it competitive grief again.

You know, the only point I want to make about this is that I understand there are a lot of explanations for what is occurring, and a lot of valid ones for what is occurring, and everyone should take notice of that. I understand that it takes time to do these things, but I would like to say, Mr. Secretary, that I survived the Reagan landslide to come here in 1980, and I am in my ninth year, and I would have to say, looking back on those nine years, I am not persuaded that our country has yet taken this thing in hand and done what has to be done to advance the interests of American businesses in the competitive marketplace.

It is certainly not critical of you, Mr. Secretary, or any individual. It is only a sense that I have that there is a kind of, I do not want to characterize it as a desperation out there, but a feeling by major American business concerns that are massively successful for generations that something is just not quite right.

Now I just want to give you an example, if the Chairman will indulge me. There is a news account right now that indicates that Vice Chairman Johnson of the Federal Reserve believes that Japan can strengthen its currency by raising its interest rates, but that Japan is reluctant to do so because it fears that such a measure would further weaken its plummeting stock market.

Now it just seems to me that, either the Japanese should raise their interest rates to strengthen the yen, or we should be concerned with whether the Federal Reserve ought to be looking at lowering U.S. interest rates to accomplish that goal.

There ought to be something done, it seems to me, to try to address these things in a very major way. Again, this is not to be critical at all of you, Mr. Secretary, or of any particular person, but it seems if the next round of talks are sometime soon that we ought to be trying to do something about these kinds of things.

I would just appreciate your response. None of it is at all critical, I assure you, of you.

Secretary MULFORD. You may remember that I am from Rockford, Illinois—

Senator DIXON. A great city. Peoria and Rockford are great cities, yes, sir.

Secretary MULFORD [continuing]. Which some years ago passed Peoria in size. [Laughter.] In all seriousness—

Senator SARBANES. Senator Dixon loves both cities. [Laughter.]

Secretary MULFORD. I do feel that I have a good understanding and background on the sort of general Midwest heavy-industry sort of realities. Believe me, that is one of the things that caused me to take the views that I did after 1985, that we had to find some way to alter a course which was clearly damaging our manufacturing capability, our export capability, and so on.

And I feel that a great deal has been accomplished up till now to restore, improve, or at least reverse the worst parts of that situation. I think that the resolution of the problems, however, is highly complex. I have no comment on your points about relative interest rates, but I would say, for example, that if Japan were to raise interest rates and one of the effects of that were to substantially slow domestic growth, then Japan would not pull in imports that it does pull in from the United States and help our situation. So there is a negative side to it, too, if that were to be the course.

Another part of this is the United States' inability to reduce its fiscal deficit which clearly contributes to our lack of saving, our lack of investment, our lack of competitiveness. These are the sort of fundamental issues that we need to address to cure our competitive problems. My point is that, yes, exchange rates are very, very important, and they are right there on the front line when you are in the business making the sale. That is true. But they are not the whole story when it comes to how to make these adjustments and how to remain competitive.

As I said earlier, the yen I think has moved in recent months in a way that many experts feel is not really in line with the underlying economic fundamentals in Japan. Whether you think it is related to a lack of confidence politically in Japan, or some of the points I made about the liquidation of assets, the readjustment of asset values, exiting the currency, and so on, I think it is important to recognize that again one has to take a longish-term view because these are long-term problems.

As I have said, we are clearly aware of and concerned about that situation. We express that in the communiqué. I have expressed that here this morning. We need to keep in mind the other factors, and we will watch the situation very, very closely—I can give you my assurance of that—and we are concerned about it.

Senator SARBANES. Well, I think it is very important, if the Senator will permit me, to make sure that these evaluations of how things are performing have a relative dimension to them.

In other words, I know the Japanese are saying well, you know, we have reduced the imbalance by 13 percent. Now on the face of it, you know, it is a reduction, obviously. It even sounds—it is a double-figure reduction, and so forth. But, you know, if you then make the comparison that in the same time frame Germany has reduced 47 percent, Canada 27 percent, the NIC's 29 percent, all of the European community 96 percent, you end up sort of saying not that it is a pretty good job, but why is it not much better.

It seems to me that that needs to be kept in the forefront. It really leads me to ask you this question: Would you say that in the post-War period, the United States as a concomitant of its sort of economic leadership role took decisions deliberately to hold down trade balances? I mean, we ran trade balances, but we could have run much larger trade balances if that had been our only objective, but realizing the need for world economic growth and our responsibility to contribute to it.

We in effect tried to restrain the size of positive trade balances we might have run. Would that be a fair view of American policy over at least a good part of the post-War period?

Secretary MULFORD. I do not know that I could put it exactly that way. I would put it a little differently, I think. That is to say, that the United States has always exercised a strong sense of international responsibility in its policies. I think if we are going to preserve the global free trading system, we have to insist that countries like Japan, Korea, Taiwan, China for that matter, and others who have become major participants in that system and beneficiaries of it, do their part to share their burden of adjustment.

Clearly Japan up till now has not done its part.

Senator SARBANES. How about Germany as well? I am struck by your statement here that significant external imbalances have emerged with Germany registering a massive current-account surplus of \$53 billion in 1989, or 4.4 percent of GNP, the largest such ratio in the G-7.

Secretary MULFORD. That is what is referred to in the G-7 as a "family matter." That is to say that the surplus in Germany is within Europe. We have improved bilaterally with Germany. They have built this imbalance, which we think is unfortunate, and we have criticized and sought to adjust. But they have built that with Europe.

That is why I think what is happening with the unification of Germany is going to be very positive, because their current account surplus, when the investment needs of East Germany pick up, should be very substantially reduced allowing for stronger growth in Germany, stronger growth in the whole of Europe, and an adjustment of those internal imbalances. And, incidentally, it should improve our competitive position with Europe as a whole.

This could be quite a positive development over time.

Senator SARBANES. What do you expect to be on the agenda at the summit flowing out of this general area that we have been addressing this morning? What, if anything, would be on the agenda of the summit flowing out of this general area that we have addressed this morning?

Secretary MULFORD. Clearly the issue of the condition of the global economy and of economic policy coordination will be on the

agenda of the summit. So will the issue of trade, the approach and conclusion of the Uruguay Round, for example. That is an issue that will be under discussion. The summit does not engage in detailed discussions of exchange rates in general, but it does apprise itself of the global economy conditions for continuing adjustment, in particular, the health of the economy, growth, and inflation adjustment.

Senator SARBANES. In what form could this question of surplus countries, assuming the international responsibilities that go with running large surpluses be taken up?

Secretary MULFORD. This is an issue which has been a major issue within the G-7 process among the G-7 Ministers of Finance and Central Bank Governors. It is an issue which the summit will also be concerned about because it encompasses many of the points that have already been made about the concerns of heads of state about the general condition of the global economy.

If, for example, the adjustment process is not going well, then that does not bode well for the performance of the global economy and that becomes a major issue.

Senator SARBANES. Well, Mr. Secretary, we thank you very much for your testimony and for the report. We look forward to continuing to monitor the situation very closely. If you could, let us have the supplemental material you were going to provide on the People's Republic of China. We would appreciate that very much.

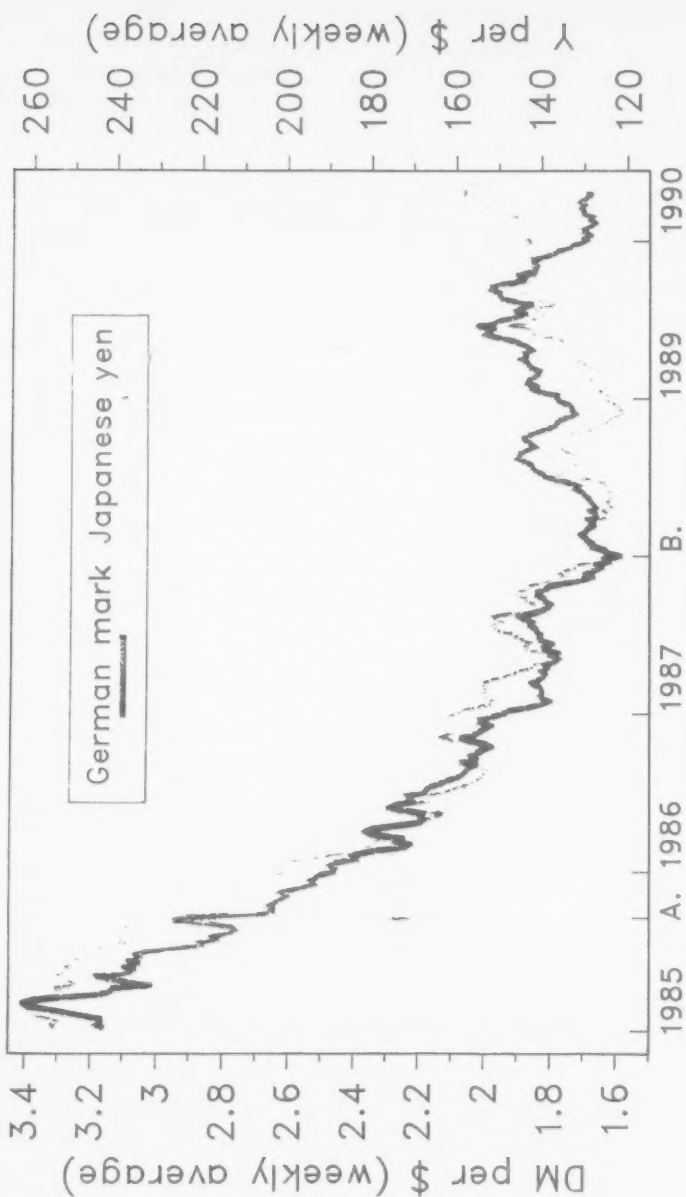
Secretary MULFORD. Mr. Chairman, I have some exchange rate graphs that I will leave with you that show the movement of the yen and the DM against the dollar since 1985, and shows since around 1987 reasonable stability. I will just leave those here for you, and members of the committee.

Senator SARBANES. Very good. We appreciate that.

The committee stands adjourned.

[Whereupon, at 11:25 a.m., the hearing was adjourned.]

# The Dollar since 1985...



A. Plaza Accord.....Sep. 22, 1985

B. 40yr Lows(DM 1.5615, Y 120.20)...Jan. 4, 1988

4/18/90

CHINA: EXCHANGE RATE POLICYQUESTION:

Does China "manipulate" its exchange rate for competitive advantage within the meaning of the 1988 Trade Act?

BACKGROUND:

1. Legislation. Section 3004 of the 1988 Trade Act requires the Treasury to "consider whether countries manipulate the rate of exchange between their currency and the U.S. dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade." Such "manipulation" triggers the need for negotiations if a country has (1) "material global current surpluses; and (2) significant bilateral trade surpluses with the United States."

2. Exchange Rate System. China has a dual exchange rate system. There is an administered ("managed float") exchange rate which applies to transactions under the state trade plan. There is also a "floating" rate determined in the "foreign exchange adjustment (swap) centers" where foreign investment corporations and all domestic entities which are allowed to retain foreign exchange can conduct foreign exchange transactions based on rates agreed by the buyer and seller. The swap centers were instituted in 1986 and have since then grown significantly in number (80) and breadth of transactions. In addition to the official dual system, there is an active black market for foreign exchange trading.

3. Exchange Rate Developments. There has not been a consistent pattern of nominal yuan devaluations since 1985. The yuan was devalued by 15% in 1985. In 1986, the yuan was devalued by 17%. The administered rate was, in December 1989, devalued in nominal terms by 21% to Yuan 4.72/US\$1 due to a stagnation in exports. The IMF encouraged this depreciation to allow for the eventual relaxation of import restrictions.

Table 1: Exchange Rate and Inflation

|                         | <u>1985</u> | <u>1986</u> | <u>1987</u> | <u>1988</u> | <u>1989</u> |
|-------------------------|-------------|-------------|-------------|-------------|-------------|
| Exchange Rate (Yuan \$) | 3.20        | 3.72        | 3.72        | 3.72        | 4.72        |
| Nominal Ex. Rate Index  | 100         | 116         | 116         | 116         | 148         |
| CPI Index               | 100         | 107         | 116         | 140         | 163         |

Devaluation of the yuan since 1986 has not been sufficient to offset the impact of rising prices in China [see Table 1]. (Inflation averaged 7.2% in 1987, 18.6% in 1988, and 20% in 1989.) In real terms, thus, the exchange rate is overvalued against the dollar. In addition, the exchange rates in the swap centers and black market are weaker than the administered rate, typically by 20% and 30% respectively.

4. Current Account and Overall Trade Balance. China has characteristically had current account and overall trade deficits in recent years [see Table 2]. Even though China had a small current account surplus of \$0.3 billion in 1987, it turned back to a deficit of \$3.8 billion by 1988 and was followed by a \$4.6 billion deficit in 1989. The merchandise trade balance also worsened during the same period, moving from a \$1.7 billion deficit in 1987 to a \$5.5 billion deficit in 1989.

Table 2: Current Account and Trade Balance (\$ Bn.)

|                      | 1985  | 1986 | 1987 | 1988 | 1989 |
|----------------------|-------|------|------|------|------|
| Current Account      | -11.8 | -7.3 | 0.3  | -3.8 | -4.6 |
| Global Trade Balance | -13.1 | -9.1 | -1.7 | -5.3 | -5.5 |
| Trade Surplus w/U.S. | 0     | 1.7  | 2.8  | 3.5  | 6.2  |

5. Trade Surplus with the United States. China has a large and growing trade surplus with the United States [see Table 2]. According to U.S. customs value data, China's bilateral trade surplus with the United States grew from \$2.8 billion in 1987 to \$3.5 billion in 1988 and \$6.2 billion in 1989. Clearly this is a disturbing trend.

The sharp rise in China's trade surplus with the United States stems largely from a significant increase in Chinese exports. In 1989, China's exports to the U.S. rose by 41%, following a 35% expansion in 1988. These growth rates are significantly above those for China's global exports during the same period (7% in 1989 on top of 18% in 1988).

At the same time, however, China's imports from the United States rose -- by 16% last year and 44% in 1988 -- despite China's desire to limit imports. These increases are also greater than those for China's overall imports (7% in 1989 and 28% in 1988), indicating that U.S. goods have raised their share of China's total import market.

6. Foreign Exchange Controls and External Trade. Foreign exchange at the administered rate is allocated in accordance with the issuance of import licenses to foreign trade companies under the foreign exchange plans of the central, provincial, and local governments. The PRC's primary means of controlling imports (and exports) is through the provision of licenses to trading companies, although it can issue more discrete instructions on importing. There are two types of imports: restricted and unrestricted. Restricted items can change on a monthly basis. Import priority is given to those goods which are not produced, or produced in insufficient quantity, domestically. Regulations for priority uses of foreign exchange for imports were last revised in February 1989. Priority was given to inputs for high technology, textile, and light industries and the agricultural sector. Foreign exchange purchases were prohibited for numerous consumer items, such as electronics and clothing. Since that time, there has been no change to the import license list. The number of products subject to import licensing is 53.

#### ANALYSIS AND CONCLUSION:

For a number of reasons, we conclude that China has not been directly "manipulating" its exchange rate within the meaning of the legislation. First, the PRC has not used the exchange rate aggressively to ensure export competitiveness. Devaluations have been sporadic and insufficient to fully offset the negative effects of inflation on competitiveness. Moreover, depreciation has not been associated with sustained reductions in China's external deficits. The official exchange rate is still overvalued in real terms. The spread between the official exchange rate and the rate in the swap centers and black market, which are considered a more accurate reflection of the value of the yuan, is further evidence that the exchange rate is overvalued rather than undervalued.

Second, China does not "have material global current account surpluses." In the past five years, China has only had a surplus in the current account on one occasion (a small surplus in 1987) and has had a global trade deficit each year.

China does, however, "have a significant bilateral trade surpluses with the United States." Rather than exchange rate policy, the major problem in this regard seems to be China's general administrative controls over external trade which may specifically inhibit imports from the United States, along with the strong growth in PRC exports to the U.S. market. The PRC can limit imports in many ways. Restricting allocation of foreign exchange to Chinese trading companies is just one method. In addition, given China's increasing foreign exchange shortages, import preference may be determined by which supplier offers the most attractive concessional financing.

Therefore, China does not as a matter of general practice appear to "manipulate" its exchange rate for competitive advantage. Import licensing and foreign exchange allocation are the tools of choice for controlling the external trade sector. In this regard, to the extent that China's access to international capital markets is limited as a result of the Tiananmen massacre, it will be inclined to achieve current account and trade surpluses to meet its external financial obligations.

We share your concern about our rising trade imbalance with China. We are, therefore, exploring with other agencies a strategy for addressing this problem. Moreover, we aim to press the Chinese through any available bilateral contact and in the international financial institutions (especially the IMF and World Bank) to remove restrictions on imports that discriminate against goods from the United States.



DEPARTMENT OF THE TREASURY  
WASHINGTON

ASSISTANT SECRETARY

May 21, 1990

The Honorable Paul S. Sarbanes  
Chairman  
Subcommittee on International Finance  
and Monetary Policy  
Committee on Banking, Housing, and Urban Affairs  
United States Senate  
Washington, D.C. 20510

Dear Mr. Chairman:

Enclosed please find responses to the questions submitted by Senator Riegle following the testimony of Under Secretary Mulford's April 19 testimony before the Senate Banking Subcommittee on International Finance and Monetary Policy.

Please let me know if I can be of further assistance.

Sincerely,

A handwritten signature in cursive script, appearing to read "B. Harlow", followed by a long horizontal flourish.

Bryce L. Harlow  
Assistant Secretary  
(Legislative Affairs)

Enclosure

cc: Senator Riegle

April 19, 1990 Testimony before the Senate Banking, Housing and  
Urban Affairs Committee

Senator Riegle

Q.1 You stated on page 3 of your prepared testimony that the Japanese yen has depreciated sharply in recent months and that this may have "undesirable" consequences for the global adjustment process.

On March 9 the Wall Street Journal carried an article noting the Bush Administration's concern about the depreciation of the yen, but noting that Federal Reserve Vice Chairman Manuel Johnson said "he is satisfied with current exchange rates."

Is there a difference of opinion between the Treasury and the Federal Reserve about whether the decline in the value of the yen should concern us?

Under Secretary Mulford

A.1 The common views of Secretary Brady and Chairman Greenspan are reflected in the April 7 Statement of the "Group of Seven", composed of the finance ministers and central bank governors of Canada, France, the Federal Republic of Germany, Italy, Japan, the United Kingdom and the United States. That Statement included the following paragraph:

"The Ministers and Governors discussed developments in global financial markets, especially the decline of the yen against other currencies, and its undesirable consequences for the global adjustment process, and agreed to keep these developments under review. They reaffirmed their commitment to economic policy coordination, including cooperation in exchange markets."

Senator Riegle

Q.2 News accounts have indicated that Vice Chairman Johnson of the Federal Reserve Board believes that Japan can strengthen its currency by raising its interest rates, but that Japan is reluctant to do so because of fears that such a measure would further weaken its plummeting stock market.

Does the Administration believe the Japanese should raise their interest rates to strengthen the yen, or would it prefer that the Federal Reserve lower U.S. interest rates to accomplish that goal?

Under Secretary Mulford

A.2 Exchange rate considerations should play a role in determining whether an interest rate adjustment is necessary, but the primary factor must be the need to foster non-inflationary growth of economic activity. Japan has raised its interest rates considerably in recent months. Further increases might eventually be needed if inflationary pressures emerge in Japan, but at this time we do not think such pressures are serious.

If U.S. economic developments warrant a decrease in U.S. interest rates, we would welcome the depreciation of the dollar against the yen which would be likely to occur.

Senator Riegle

Q.3 On March 29 the Journal of Commerce carried an article entitled "Low Dollar Sells Out America." The article contends that the United States should not seek to strengthen the yen because that really doesn't help our exporters market in Japan, while a strong yen does assist the Japanese in buying U.S. companies at bargain basement prices.

Are there some in the Administration who believe the weakened yen is not "undesirable" and that we should not take steps to strengthen the yen vis a vis the dollar?

Under Secretary Mulford

A.3 The Administration recognizes that we cannot rely solely on depreciation of the dollar to rectify our trade imbalance with Japan. That is one reason why we have invested much time and effort in the "Structural Impediments Initiative" negotiations with Japan, as well as multilateral macroeconomic policy coordination more generally. Nevertheless, we believe that the value of the yen relative to the dollar does affect U.S. competitiveness. I do not believe there are any Administration officials in responsible positions who are unaware of the threat that depreciation of the yen could erode the gains in U.S. competitiveness achieved by the dollar's depreciation from its 1985 highs.

Senator Riegle

Q.4 In the report which accompanies your testimony the Treasury calls attention to Germany's huge trade and current account surpluses which in 1989 were \$72 billion and \$53 billion respectively. Yet the report is quite optimistic that the unification of Germany will help correct these surpluses "over time." Can you give an indication of why Treasury believes that and what time frame we are talking about for correcting the surpluses?

A.4 Treasury's view that German unification will reduce Germany's external surpluses over time is based essentially on an analysis of macroeconomic developments that we expect will be associated with the integration of the two economies. The basic conclusion, and the underlying analysis, appears to be broadly shared by other analysts.

The effect of unification on the German external accounts may be analyzed from two complementary perspectives, each focussing on a different aspect of the same picture: a) changes in the capital account, reflecting purely financial international transactions; and, b) changes in the current account, reflecting shifts in demand for goods and services.

a. Current and Capital Account Relationship.

In recent years Germany has had a large current account surplus. The counterpart of this surplus is a capital outflow, essentially net lending to foreigners to finance their corresponding deficits. Looked at another way, domestic investment in Germany has not fully absorbed the available supply of savings so Germany has been a substantial net foreign creditor. Therefore, in order for Germany's current account surplus to fall, the surplus of saving over investment must also decline.

b. Capital Account Developments.

Unification is expected to change this situation appreciably by affecting the saving/investment balance within the expanded Germany. First, public sector demand for credit is likely to increase considerably in order to finance higher public infrastructure expenditures as well as transfer payments. Second, domestic investment spending by the German private sector is expected to be higher than it otherwise would have been. Both developments will tend simultaneously to absorb a higher portion of available domestic savings and raise total investment spending, thus narrowing the saving/investment imbalance that is at the heart of the capital outflow/current account surplus.

c. Current Account Developments.

The shift may also be seen in terms of changes in expected flows of real goods and services. Domestic demand growth in the enlarged Germany will be higher than it otherwise would have been, for several reasons. First, there will be higher demand for consumer items (such as household conveniences) by East German households. Second, there will also be new demand associated with higher investment spending for public infrastructure, corporate plant and equipment, and housing.

This discrete increase in total domestic demand -- which should persist over a number of years -- will affect the current account through several channels.

1. There will be higher domestic absorption of domestically produced goods and services, some of which would otherwise have been exported. This should apply especially to the capital goods sector, which is the backbone of the German export industry.
2. There will be higher German demand for direct imports.

In sum, unification is expected to raise domestic demand in Germany, which will be met by raising imports and diverting domestic production (and exports) to domestic needs. Financing the higher demand will absorb a larger share of available domestic savings and attract investment from abroad, reducing the current gap between savings and investment and, therefore, capital outflows.

d. Timing.

The timing of these developments will be a function of many factors, many of which are still unknown. These include, inter alia: the size of the increase in public investment and transfers, and their net budgetary effects; the amount of additional private investment and the speed with which new investment plans are implemented; the response of East German consumers to the recently announced currency conversion, and the effect of sweeping structural changes on East German household income and income expectations; the response of West German consumers to the uncertainties engendered by the whole process.

At this early stage, therefore, it is impossible to predict with any confidence either the size or the timing of the trade and current account adjustment with any confidence. However, our preliminary assessment remains that considerable adjustment is likely over the course of the next several years.

